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Alert

Fourth Circuit Reverses Disallowance of Lender's Post-Bankruptcy Legal Fees

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The Bankruptcy Code ("Code") permits "a creditor [to] assert an unsecured claim for post-[bankruptcy] attorneys' fees based on a pre-[bankruptcy] promissory note," held the U.S. Court of Appeals for the Fourth Circuit on Feb. 8, 2019. *SummitBridge Nat'l Investments III, LLC v. Faison*, 2019 WL 490573, *2 (4th Cir. Feb. 8, 2019). In a sensible opinion, the Fourth Circuit reversed the lower courts' disallowance of an undersecured lender's claim for legal fees. The court thus "join[ed] other federal courts of appeals" with its holding. *Id.*

Relevance

"Bankruptcy and district courts long have wrestled with this question, disagreeing as to whether creditors may assert unsecured claims for post-petition attorneys' fees based on pre-petition contracts." *Id.*, citing *In re Augé*, 559 B.R. 223, 229 (Bankr. D.N.M. 2016). The lower courts here either ignored or misread the Supreme Court's opinion in *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas. & Elec. Co.*, 549 U.S. 443, 452-54 (2007) ("[C]laims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed."). At least two other circuits, though, properly followed *Travelers*. *In re SNTL Corp.*, 571 F.3d 826, 844 (9th Cir. 2009) ("attorneys' fees arising out of a pre-[bankruptcy] contract but incurred post-petition fall within the … Code's broad definition of claim" and are enforceable under applicable contract and state law); *Ogle v. Fidelity & Deposit Co. of Maryland*, 586 F.3d 143, 148 (2d Cir. 2009) (same). *Accord*, *In re Tribune Media Co.*, 2018 WL 6167504 (D. Del. Nov. 26, 2018) (reversing bankruptcy court, the "courts of appeals … have unanimously … allowed unsecured claims for contractual attorneys' fees that accrued" after bankruptcy; Third Circuit had not ruled on issue). As we predicted in our Dec. 5, 2017 *Alert*, "the blinkered analysis of the lower courts in *SummitBridge* should be reversed on appeal."[1]

Facts

The individual Chapter 11 debtor owed the lender's predecessor $1.627 million, secured by real estate. Each of the debtor's notes to the lender provided for "reasonable attorneys' fees" should the "notes be placed with an attorney for collection." 2019 WL 490573, at *1. The debtor was not in default when it filed its Chapter 11 petition, but the lender's counsel was required to perform post-bankruptcy services.

The bankruptcy court later confirmed the debtor's reorganization plan that provided for the allowance of the lender's claim in the amount of $1.715 million, including principal, pre-bankruptcy interest, post-bankruptcy interest, plus fees, late fees and attorneys' fees. To satisfy the lender's secured claim in full, the debtor transferred the real estate collateral to it, without prejudice to the lender's right to assert an unsecured claim for legal fees and the debtor's right to object. The lender then filed an unsecured claim

[1] *See* "District Court Affirms Disallowance of Lender's Legal Fee Claim," *SRZ Alert*, Dec. 5, 2017, available here.

for post-bankruptcy legal fees in the amount of $302,596, equal to 15 percent of the outstanding indebtedness.

The bankruptcy court disallowed the lender's claim as a matter of law. It reasoned that Code "§§ 506(b) and 502(a) – (b) do not permit the recovery of post-petition attorneys' fees sought as unsecured claims." Affirming, the district court reasoned that the "Code expressly awards post-[bankruptcy] fees under several circumstances, none of which include an award of [fees] to an unsecured creditor." It also found the "equities [to] weigh in favor of the protection of assets for distribution to all creditors." According to the district court, allowance of the lender's claim would "reduce the pool of assets available" to other unsecured creditors.

The Fourth Circuit
Travelers. According to the Fourth Circuit, the Supreme Court, when reviewing a claim for post-bankruptcy legal fees in *Travelers*, "applied a presumption of broader significance: '[W]e generally presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed.'" 2019 WL 490573, at *2, quoting *Travelers*, 549 U.S. at 452. The "Supreme Court's 'analysis and rationale' in *Travelers* is 'equally applicable to post-petition costs arising out pre-petition contracts more generally,'" said the court. *Id*., quoting the Second Circuit's *Ogle* decision. Indeed, "both the Second and Ninth Circuits have concluded that there is no basis in the Code for barring unsecured claims for post-petition attorneys' fees arising out of pre-petition contracts." *Id*., citing *SNTL*, 571 F.3d at 839-45 and *Ogle*, 586 F.3d at 146-49. Even before *Travelers*, the Eleventh Circuit held that over-secured creditors can assert unsecured claims for post-petition attorneys' fees, assuming that unsecured and undersecured creditors could also do so. *In re Welzel*, 275 F.3d 1308, 1319 (11th Cir. 2001) (*en banc*).

The Code Allows Post-Bankruptcy Legal Fees. Code § 502(b) governs the "allowance of claims or interests" in bankruptcy cases, explained the Fourth Circuit. *Id*., at *3. Unless one of nine enumerated exceptions applies, the court must "determine the amount of such claim … as of the date of the filing of the [bankruptcy] petition, and shall allow such claim in such amount." In this case, so long as the lender "had a 'claim' for [post-bankruptcy] fees as of the petition date" and so long as that "claim [did] not fall within one or more of the nine enumerated exceptions" in § 502(b), that claim had to be allowed. *Id.* Although the right to legal fees under the debtor's notes was "contingent on a future, post-petition event — namely, the notes being placed with an attorney for collection," the "Code defines 'claim' broadly so as to include … contingent right[s] to payment." *Id.* Most important, the lender here had "the *right* to those fees" prior to bankruptcy, when the debtor "signed the promissory notes in question." *Id.* As the Ninth Circuit held, this was enough "to make the fees 'pre[-] petition in nature, constituting a contingent pre[-]petition obligation that bec[omes] fixed post[-] petition when the fees [are] incurred. '" *Id.*, citing *SNTL Corp.*, 571 F.3d at 844.

The court rejected the debtor's argument that the lender had incurred no legal fees on the date of bankruptcy. Under the Second Circuit's *Ogle* decision and *Travelers*, it found that § 502(b) "does not bar recovery of post-petition attorneys' fees." *Id.* at *4, quoting *Ogle*, 586 F.3d at 147. Moreover, if a claim with no value on the date of bankruptcy could not be allowed under § 502(b), "there would be no need for §502(b)(2), an enumerated exception to §502(b) that specifically disallows claims for 'unmatured interest.'" *Id.* Finally, because § 502(c) provides for a bankruptcy court's estimation of contingent or unliquidated claims in order to avoid delay in the administration of a bankruptcy estate, "there would be no need for such estimates" if that claim had to be liquidated on the date of bankruptcy. "In sum," said

the court, "like our sister circuits, we can find nothing in §502(b) that expressly disallows unsecured claims for post-petition attorneys' fees." *Id.*

Nor does § 506(b) bar the lender's unsecured claim for post-petition legal fees. It merely provides that "creditors with over-secured claims — that is, creditors with collateral that exceeds the amount of their claims — may add to their secured claims both interest and reasonable attorneys' fees." *Id*. According to the Fourth Circuit, *Travelers* "made clear that claims enforceable under state law are presumed allowable, and … this presumption may be overcome only by an *express* disallowance." *Id.* at *5, citing 549 U.S. at 452. "And § 506(b) never mentions, let alone expressly disallows, unsecured claims for post-petition attorneys' fees." *Id.*, citing *Ogle*, 586 F.3d at 148. Indeed, "in specifying that over-secured creditors may treat as *secured* their claims for reasonable attorneys' fees, §506(b) gives those claims priority over other creditors' unsecured claims." *Id.*, citing *Welzel*, 275 F.3d at 1318.

When Congress wanted to disallow a claim for legal fees, it did so in "§502, not §506 … . And as the Supreme Court explained in *Travelers*, the 'absence of an analogous provision excluding' claims for a different category of fees — in this case, unsecured claims for post-petition fees — is strong evidence that Code does not expressly disallow those claims." *Id.* at *6, quoting *Travelers*, 549 U.S. at 453.

The Fourth Circuit also rejected the debtor's reliance on Code § 506(b) to "deny under[-] secured creditors post[-] petition interest on their claims." *Id.* "[C]laims [for] unmatured interest (unlike attorneys' fees) are expressly disallowed under §502(b)(2) … . [B]ecause §502(b) does 'not contain a similar prohibition against [allowance of] attorneys' fees, the comparison between the current issue and that presented in *United Savings Ass'n. of Texas v. Timbers of Inwood Forest Associates, Ltd*, 484 U.S. 365, 372 (1988) is not persuasive." *Id.*, citing *SNTL*, 571 F.3d at 844 and *In re Dow Corning Corp.*, 456 F.3d 668, 682 (6th Cir. 2006).

Policy Considerations Rejected. Rejecting the debtor's policy argument (fairness to other unsecured creditors), the Fourth Circuit found it had "no basis in the text of the relevant Code provisions … . " *Id.*, at *7. "If otherwise secured creditors recover on unsecured claims for post-petition attorneys' fees, those payments may come at the expense of unsecured creditors' ability to recover fully on their claims to principal [,] … [b]ut a basic tenet of bankruptcy law is that secured creditors are privileged over unsecured creditors." *Id.* at *7.

Finally, as the Supreme Court held in *Travelers*, "state law governs the substance of claims … . Congress … generally left the determination of property rights in the assets of a bankrupt's estate to state law." *Id.* at *7, quoting 549 U.S. at 450-51. Here, the lender "bargained specifically for attorneys' fees under state law to enforce those rights in bankruptcy … even if it reduces the pool of assets otherwise available … ." *Id.* Only Congress, "not the courts," can adjust any asserted "tension between this policy of vindicating contract rights enforceable under state law and other bankruptcy principles." *Id.*

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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