ALERTS

District Court Affirms Disallowance of Lender's Legal Fee Claim

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"[T]he Bankruptcy Code does not permit [an undersecured] creditor . . . to advance an unsecured claim for post-[bankruptcy] attorneys' fees," held the U.S. District Court for the Eastern District of North Carolina on Nov. 27, 2017. *Summitbridge Nat'l Invs. Iii v. Faison*, 2017 U.S. Dist. LEXIS 195267, *8 (E.D. N. C. Nov. 27, 2017). Affirming the bankruptcy court, the district court agreed that "the Code is most properly interpreted to allow only oversecured creditors to add post-[bankruptcy] attorneys' fees." *Id.*, at *10.

Relevance

Both the district and bankruptcy courts recognized that "a number of courts . . . hold generally that post-[bankruptcy] attorney's fees are allowable as an unsecured claim, irrespective of whether the creditor is oversecured." *Id.*, at *7 (emphasis added), citing *In re 804 Congress, L.L.C.*, 756 F.3d 368 (5th Cir. 2014) *on remand*, 529 B.R. 213, 227-28 (Bankr. W. D. Tex. 2015) ("unreasonable" commission under § 506(b) still "enforceable" unsecured claim under state law); *In re SNTL Corp.*, 571 F.3d 826, 844 (9th Cir. 2009) (*held*, "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 relevant contract and state law); *In re Welzel*, 275 F.3d 1308 (11th Cir. 2001) (*en banc*); and *Ogle v. Fidelity & Deposit Co. of Maryland*, 586 F.3d 143, 148 (2d Cir. 2009). Still, because of a purported "absence of binding [Fourth] Circuit precedent," the district court accepted the reasoning of other lower courts that "unsecured creditors are not entitled to post-[bankruptcy] attorneys' fees. *Id.*, at *9.

As shown below, the blinkered analysis of the lower courts in *Summitbridge* should be reversed on appeal. The Fourth Circuit had, in fact, decided a similar case in 1999, reversing lower court decisions for "inappropriately" focusing on bankruptcy issues instead of the terms of a contract and "applicable state law." *In re Shangra-La*, 167 F.2d 843, 848 (4th Cir. 1999).

Facts

The individual Chapter 11 debtor owed Summitbridge'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 note be placed with an attorney for collection." *Id.*, at *2. The debtor "was not in default" when "the Chapter 11 petition was filed," but Summitbridge's counsel performed post-bankruptcy services. *Id.*

The bankruptcy court later confirmed the debtor's reorganization plan which provided for the allowance of the lender's claim in the amount of $1.715 million, including "principal, pre-[bankruptcy] interest, and post-[bankruptcy] interest, appraisal fees, late fees, and attorneys' fees." *Id.* 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 for post-bankruptcy legal fees in the amount of $302,596, "equal to 15% of the outstanding indebtedness." *Id.*, at *3.

The bankruptcy court disallowed the lender's claim as a matter of law. It reasoned that Bankruptcy Code "§§ 506(b) and 502(a)-(b) do not permit the recovery of post-petition attorneys' fees sought as unsecured claims." *Id.* Because "post-petition attorneys' fees [are] governed by [Code §] 506," reasoned the bankruptcy court, that section "by its express terms applies only to oversecured creditors." *Id.*, at *4. Summitbridge was undersecured (i.e., its underlying claim exceeded the value of its collateral) and thus had no allowable claim for legal fees, reasoned the bankruptcy court.

The District Court

The district court affirmed, reasoning that the "Code expressly awards post-[bankruptcy] fees under several circumstances, none of which include an award of [these] fees to an unsecured creditor." *Id.*, at *9. Finally, the court found the "equities [to] weigh in favor of the protection of

assets for distribution to all creditors." *Id.*, at *10. To allow the lender's claim here, it reasoned, would "reduce the pool of assets available" to other unsecured creditors. *Id.*

Critique

At least five Courts of Appeals have taken a sensible contrary approach to allowing an undersecured creditor's claim for legal fees: if the claim is valid under applicable state law, it is allowable. A comprehensive decision of the Second Circuit, holding that a creditor was entitled to its post-bankruptcy legal fees incurred under a pre-bankruptcy indemnity agreement, illuminates the entire issue and guts the district court's flawed analysis in *Summitbridge*. *Ogle v. Fid. & Deposit Co. of Md.*, 586 F.3d 143 (2d Cir. 2009). Affirming the lower courts, the Second Circuit explained that the Code "interposes no bar . . . to recovery." *Id.*, at 148 (citing *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 452 (2007) ("[C]laims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed.").

1. *The Ogle Analysis Should Govern.* Lenders, financial advisors, accountants, indenture trustees and other professionals who bargain for reimbursement of their legal fees should be reassured by *Ogle*. Lower courts in the Second Circuit and elsewhere had previously disallowed creditors' professional fees, wrongly holding that (a) nothing in the Code authorizes the payment of these fees, and that (b) contractual rights to these fees are unenforceable. *See*, *e.g.*, *J.P. Morgan Trust Co., N.A. v. A.P. Green Indus., Inc.*, No. 06-0885, slip op. at 4 (W.D. Pa. Nov. 5, 2007) (affirmed bankruptcy court's denial of indenture trustee's reimbursement claim for legal fees; "Under the maxim of *expressio unius est exclusio alterius* (the expression of one is the exclusion of the alternatives), silence as to undersecured claims for attorneys' fees and costs in [Code] § 506(b) indicates that they are excluded from payment."); *In re Crafts Retail Holding Corp.*, 378 B.R. 44, 50 (Bankr. E.D.N.Y. 2007) ("[A]bsent statutory authority, [financial advisor's] claimed contractual rights or asserted principles of equity alone do not constitute cognizable bases for an award of compensation or reimbursement of expenses in bankruptcy cases."). According to the Second Circuit in *Ogle*, the courts had been "closely divided on the" issue of post-bankruptcy fees. 586 F.3d at 145. *Compare In re SNTL Corp.*, 571 F.3d 826, 839-45 (9th Cir. 2009) (allowing unsecured guarantor's reimbursement claim for post-petition

attorneys' fees based on pre-petition contract); *Martin v. Bank of Germantown*, 761 F.2d 1163, 1168 (6th Cir. 1985) (". . . creditors are entitled to recover attorneys' fees in bankruptcy claims if they have a contractual right to them valid under state law . . ."; collection costs and legal fees in lender's note); *In re Shangra-La, Inc.*, 167 F.3d 843, 848-49 (4th Cir. 1999) ("Entitlement to attorneys' fees . . . depended on . . . terms of [contract] and on state law."), with *Adams v. Zimmerman*, 73 F.3d 1164, 1177 (1st Cir. 1996) (disallowing claim for post-insolvency fees against FDIC receiver; non-bankruptcy case), and *In re Waterman*, 248 B.R. 567, 573 (B.A.P. 8th Cir. 2000) (allowing claim for post-petition fees under Code § 506(b) only because creditor was oversecured).

The claim for attorneys' fees in *Ogle* arose from a series of pre-bankruptcy agreements between Fidelity and Agway. In exchange for Fidelity's providing surety bonds to Agway's insurers, Agway agreed to indemnify Fidelity for any payments made under the bonds plus any legal fees incurred enforcing the agreements. 586 F.3d at 145. After filing its Chapter 11 petition, Agway defaulted on its obligations to the insurers. Fidelity complied with its obligation under the bonds and tendered payment to Agway's insurers. Fidelity's efforts to enforce its indemnity rights against Agway, however, resulted in protracted litigation during which Fidelity incurred costs, including attorneys' fees. *Id.* The Second Circuit considered this narrow issue: "Under the Bankruptcy Code, is an unsecured creditor entitled to recover post-petition attorneys' fees that were authorized by a pre-petition contract but were contingent on post-petition events?" *Id.* The court answered affirmatively because the Code does not bar these claims.

1. *Code § 502(b) Not a Bar to Recovery.* The court first rejected the trustee's argument in *Ogle* that Code § 502(b) precluded the legal fees sought by Fidelity. Quoting the Supreme Court in *Travelers*, the Code defines "claim" to be a "right to payment," which "usually refer[s] to a right to payment recognized under state law." *Id.*, at 146. (*Travelers*, 549 U.S. at 451) (internal quotation marks omitted).

The contingent nature of the creditor's claim in *Ogle* was also unimportant. As the court explained, Code § 101(5)(A) includes "contingent" claims in its definition of "'claim." *Id.* Because applicable state contract law gave the creditor a right to payment when the indemnification agreement was signed, the creditor "possessed a contingent right to post-petition attorneys' fees," although "its right arose

pre-petition." *Id.* Moreover, nothing in Code § 502(b) precludes an unsecured creditor's recovery of post-petition attorneys' fees merely because the claim was contingent. *Id.*, at 146-147. *Accord*, *In re SNTL Corp.*, 571 F3d 826, 838 (9th Cir. 2009) ("Under section 502(b)(1), those contingent claims cannot be disallowed simply because the contingency occurred postpetition . . . . Contingent claims are allowed under Section 502(b)."). According to the Second Circuit, the Supreme Court's *Travelers* opinion required it to "presume that claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed."

Moreover, none of the exceptions to the allowability of a claim listed in § 502(b) applied to the claim in *Ogle*. Although § 502(b)(1) makes any defense to a claim available to a bankruptcy trustee, unless applicable state law or one of the exceptions in § 502(b) applies, "the claim must be allowed.'" *Id.*, at 147 (quoting *Travelers*. 549 U.S. at 452).

The Second Circuit's reasoning is straightforward:

The underlying contract is valid as a matter of state substantive law; none of the § 502(b)(2)-(9) exceptions apply; and the Code is silent as to the particular question presented—. . . whether the Code allows unsecured claims for fees incurred while litigating issues of contract law more generally.

Id., at 476 (internal quotation marks omitted).

1. *Code § 506(b) Not a Bar To Recovery*. The Second Circuit in *Ogle* also rejected the trustee's reliance on Code § 506(b), which only bars *interest* on an *undersecured* creditor's claim. Because Code § 506(b) "does not implicate unsecured claims for post-petition attorneys' fees," reasoned the court, it thus "interposes no bar to recovery." *Id. Accord. In re SNTL Corp.*, 57 F3d at 841 (". . . we reject the argument that section 506(b) preempts postpetition attorneys' fees for all except oversecured creditors."), citing *In re 268 Ltd.*, 789 F.2d 674, 678 (9th Cir. 1986) (§ 506(b) does not "limit the fees available" as an unsecured claim but merely "define[s] the portion of the fees [to] be afforded secured status,"); *In re Welzel*, 275 F.3d 1308, 1316-20 (11th Cir. 2001) (§ 502(b) "does not . . . . disallow attorneys' fees of creditors . . . .").

2. *Timbers Not a Bar to Recovery.* Nor does the Supreme Court's holding in *United Savings Ass'n v. Texas Timbers of Inwood Forest Assocs Ltd.*,

484 U.S. 365 (1988), mandate disallowance of unsecured claims for post-bankruptcy legal fees. Although § 502(b)(2) "specifically disallows claims for unmatured interest," § 502(b) "does not contain a similar prohibition against attorneys' fees." *SNTL Corp.*, 571 F.3d at 844. As the Second Circuit stressed in *Ogle*, "while section 502(b)(2) bars claims for unmatured interest, it does not similarly bar (or even reference) claims for post-petition attorneys' fees." *Id.*, at 148.

3. *No Unfairness.* Finally, the Second Circuit rejected the trustee's policy argument in *Ogle* that allowance of the fees would "unfairly disadvantage other creditors . . . whose distributions would be reduced." *Id.*, at 149. Sophisticated parties in *Ogle* negotiated an agreement with a provision for the recovery of legal fees. The creditor will not be receiving an undeserved bonus at the expense of others. Allowance of the claim "'merely effectuates the bargained-for terms of the [pre-bankruptcy] loan contract.'" *Id.* (quoting *In re United Merchants & Mfrs., Inc.*, 674 F.2d 134, 137 (2d Cir. 1982) (pre-Code case)). *See SNTL Corp.*, 571 F.3d at 845 (". . . the Bankruptcy Code itself [does] not specifically disallow . . . postpetition fees . . . . In the end, it is the province of Congress to correct statutory dysfunctions and to resolve difficult policy questions embedded in the statute.").

4. *Stubborn Lower Courts.* Some lower courts simply ignored or misread the Supreme Court's *Travelers* decision, as did the court in *Summitbridge*. *See, e.g., A.P. Green Industries, supra* (Section 506(b), dealing with a secured creditor's claim for legal fees, "controls over the general statute, section 502(a)"; secured creditors "are able to collect [legal fees] only to the extent that there is a security cushion from which they can be paid"; "to allow contractual claims for attorneys' fees . . . would impair the debtor's fresh start . . . while treating similarly situated creditors differently."). Another bankruptcy court asserted, despite the *Travelers* holding, that it had never approved a pre-bankruptcy contractual legal fee reimbursement clause and that, in any event, the clause "was not in compliance with federal bankruptcy law, i.e., [Code] §§ 327 and 330." *Crafts Retail* 378 B.R. at 51 (relying on *In re United Merchants & Manufacturers, Inc.*, 597 F.2d 348 (2d Cir. 1979) (denying legal fees to indenture trustee), but ignoring *In re United Merchants & Manufacturers, Inc.*, 674 F.2d 138-39 (2d Cir. 1982) (". . . we find no law or policy that supports the . . . disallowance of . . . claims . . . for collection costs under . . . the loan agreements"; distinguished compensation for expenses in administering the estate from "claims

[that] are part of the contractual indebtedness [to creditors], and [thus] not subject to the statutory limitations on reimbursement for expenses of administering the estate.").

The bankruptcy court in *Crafts Retail* also stressed the lack of an express Code provision authorizing the reimbursement of a financial advisor's pre-bankruptcy contractual claim for post-bankruptcy legal fees. 378 B.R. at 44. In its view, the "morphing of attorney compensation into a garden variety expense item is unacceptable . . . ." *Id.* Other bankruptcy courts reached similar conclusions. *In re Elec. Mach. Enter., Inc.*, 371 B.R. 549, 551-52 (Bankr. M.D. Fla. 2007) (stating that the Supreme Court in *Travelers* "declined to express an opinion on whether unsecured creditors are entitled to post-petition attorneys' fees. . . ."; "plain language" of § 506(b) precludes claims); *In re Pride Cos., LP.*, 285 B.R. 366, 372-75 (Bankr. N.D. Tex. 2002) (rejected Second Circuit's 1982 *United Merchants* decision for its purportedly questionable "logic and importance.").

1. *Consistent Appellate Decisions.* At least five, if not six, Circuits have now put to rest the contractual post-bankruptcy legal fee issue. But there is still no uniformity in the lower courts, as *Summitbridge* shows. Outside the Second, Fifth, Sixth, Ninth and Eleventh Circuits, the contractual legal fee issue is still open.

But even the Fourth Circuit should be convinced to reverse the district court in *Summitbridge*. Reversing the lower courts in a similar case, the Fourth Circuit held that they had "inappropriately focuse[d] on the presence of issues peculiar to bankruptcy law, rather than on whether . . . attorneys' fees are properly recoverable under the terms of the lease and applicable state law." *In re Shangra-La, Inc.*, 167 F.3d 843, 848 (4th Cir. 1999). The district court in *Summitbridge* inexplicably ignored the *Shangra-La* decision.

In that case, a commercial landlord claimed post-bankruptcy legal fees after the Chapter 7 trustee assumed the debtor's lease. Reversing the lower courts' denial of the claim, the Fourth Circuit went "back to state contract law [to determine] the terms of default and the landlord's rights upon default under the lease." *Id.* As the court stressed, "[a]ttorneys' fees qualify as . . . losses when state law would recognize them as such." *Id.*, at 850. Merely because "federal bankruptcy law" issues "were involved will not preclude an award of fees" on remand. *Id.*

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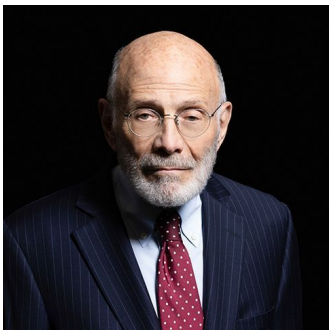

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