Can an Unsecured Creditor Recover Post-Petition Attorneys Fees?

The Question Not Answered in *Travelers*

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Editor's Note: *Please see related article on p. 28.*

A secured creditor can recover reasonable attorneys' fees incurred post-petition if the creditor is oversecured and if the agreement or state statute under which the secured claim arose provides for such fees.[2] Can an unsecured creditor also recover attorneys' fees incurred post-petition if its agreement with the debtor similarly provides for such fees? In the Ninth Circuit, before March 2007, the answer would mostly likely have been "no." Under the Ninth Circuit's *Fobian* rule, an unsecured creditor could not recover any attorneys' fees incurred while litigating "issues peculiar to federal bankruptcy law," even if the parties' agreement expressly provided for the recovery of attorneys' fees in the bankruptcy context.[3] On March 20, 2007, in *Travelers Casualty & Surety Co. v. Pacific Gas & Elec. Co.*, the U.S. Supreme Court, in an unanimous decision written by Justice Alito, overruled the *Fobian* rule, holding that *Fobian* "finds no support in the Bankruptcy Code" and was improperly created as a matter of federal common law.[4]

Travelers v. Pacific Gas & Elec. Co. (PG&E)


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Travelers issued a surety bond to guarantee PG&E's payment of state workers' compensation benefits to injured employees. The parties' indemnity agreement provided that PG&E would be responsible for any loss Travelers might incur in connection with the bond, including attorneys' fees incurred in pursuing, protecting or litigating Travelers' rights in connection with the bond.

Even though Travelers had not been called upon to make a payment under the bond, Travelers filed a proof of claim in PG&E's chapter 11 bankruptcy case, which included a claim for the attorneys' fees it had incurred during PG&E's bankruptcy case. PG&E, relying in part on the *Fobian* rule, objected to Travelers' claim for attorneys' fees. The bankruptcy court agreed with PG&E and disallowed Travelers' claim for attorneys' fees. The district court and the Ninth Circuit affirmed. The Supreme Court reversed the Ninth Circuit on the grounds that "[t]he *Fobian* rule finds no support in the Bankruptcy Code, either in §502 or elsewhere."[5] The Court noted that "even where a party in interest objects [to a claim], the court 'shall allow' the claim except to the extent that the claim implicates any of the nine exceptions enumerated in §502(b)."[6] Because Travelers' claim for attorneys' fees did not implicate any of the exceptions in §502(b)(2) through (9), the claim "must be allowed under §502(b) unless it is unenforceable within the meaning of §502(b)(1)."[7]


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The Court explained that under §502(b)(1), if a claim is enforceable under any agreement or applicable state law, then that claim must be allowed in bankruptcy unless the Code expressly states otherwise. The *Fobian* rule "inverts the proper analysis...by allowing attorneys' fees only where they are expressly authorized by the Bankruptcy Code."[8] Notably, the Court did not determine the allowability of Travelers' claim, and remanded the case for further proceedings.

The Significance of Travelers*: The* Butner *Principle and Statutory Interpretation*

The *Travelers* decision is important because it reaffirms basic federalism principles in the bankruptcy context, which has implications on how to interpret sections of the Code that refer explicitly or implicitly to state law or "applicable nonbankruptcy law."[9] Under the *Butner* principle, bankruptcy courts should apply state law to determine the substance and validity of claims unless some federal interest requires a different result.[10]

In accordance with the *Butner* principle, the Supreme Court previously cautioned in *Atherton v. FDIC* against the judicial creation of federal common law, even in the context of federal statutes, when those federal statutes were enacted against the background of state law:

> The Court has said that cases in which judicial creation of a special federal rule would be justified...are few and restricted. Whether latent federal power

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Supreme Court Update

1 The views expressed in this article are those of the authors and do not necessarily represent those of Winstead PC.

2 11 U.S.C. §506(b).

3 *In re Fobian*, 951 F.2d 1149, 1153 (9th Cir. 1991).

4 — U.S. —, Case No. 05-1429, 2007 WL 816795 at *7 (March 20, 2007).

5 2007 WL 816795 at *8.

6 2007 WL 816795 at *5.

7 2007 WL 816795 at *5.

8 2007 WL 816795 at *7, *citing Collier on Bankruptcy.*

9 *See, e.g.*, 11 U.S.C. §§346(b), 364(f), 507(a)(1) and 522(b)(2).

10 *Butner v. U.S.*, 440 U.S. 48, 55 (1979).

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> should be exercised to displace state law is primarily a decision for Congress, not the federal courts. Nor does the existence of related federal statutes automatically show that Congress intended courts to create federal common-law rules, for Congress acts against the background of the total *corpus juris* of the states. Thus, normally, when courts decide to fashion rules of federal common law, the guiding principle is that a significant conflict between some federal policy or interest and the use of state law...must first be specifically shown.[11]

In *Travelers,* the Court reaffirmed the *Butner* principle and criticized the *Fobian* rule as an unnecessary creation of federal common law:

> [W]e have long recognized that the basic federal rule in bankruptcy is that state law governs the substance of claims, Congress having generally left the determination of property rights in the assets of a bankrupt's estate to state law... The [Ninth Circuit] nevertheless rejected Travelers' claim based solely on a rule of that court's own creation—the so-called *Fobian* rule... The *Fobian* rule finds no support in the Bankruptcy Code, either in §502 or elsewhere.[12]

Even though the *Travelers* decision did not cite *Atherton,* the Court's rejection of the *Fobian* rule is in harmony with *Atherton*'s significant-conflict test as to whether courts should create federal common law. The *Fobian* rule was created without a showing of "significant conflict" between federal policy and the use of state law.

Atherton's significant-conflict test and *Travelers*' reaffirmation of the *Butner* principle necessarily affects the interpretation of any Code section that refers to state law. For example, 11 U.S.C. §365(d)(3) refers to "*obligations* of the debtor [that] aris[e]...under any unexpired lease of nonresidential real property" (emphasis added). The Code does not define "obligations." However, §365(d)(3) refers to "obligations... arising...under [a] *lease*," and leases are generally governed by state law. Courts therefore look to that lease to determine what "obligations" a debtor may have under §365(d)(3) instead of creating a federal common law definition for "obligations" in §365(d)(3).[13] This is consistent with the *Butner* principle and *Atherton*'s significant-conflict test. Other Code sections may be affected by *Travelers*' re-affirmation of the *Butner* principle.[14]

The *Travelers* decision is also important because it is the most recent example of the Court's approach toward

11 *Atherton v. FDIC,* 519 U.S. 213, 218 (1997) (internal quotation marks and citations omitted).

12 2007 WL 816795 at *6-7 (internal quotation marks omitted).

13 *In re Montgomery Ward Holding Corp.,* 268 F.3d 205, 209-11 (3d Cir. 2001) ("In the context of a lease contract, it seems to us that the most straightforward understanding of an obligation is something that one is legally required to perform *under the terms of the lease*...") (emphasis added; citing cases); *see, also, In re CCI Wireless, LLC,* 279 B.R. 590, 594 (Bankr. D. Colo. 2002).

14 Courts' interpretation of §502(b)(6), which involves a cap on landlord's damages resulting from the termination of a lease, is arguably inconsistent with *Atherton*'s significant-conflict test and the *Butner* principle. Many courts apply a federal common-law definition for "rent" in §502(b)(6), even though the federal common-law approach could re-write the terms of the lease on its meaning of "rent." *See In re McSheridan,* 184 B.R. 91, 99 (B.A.P. 9th Cir. 1995) (setting out a three-part federal common-law definition for "rent" in §502(b)(6)).

statutory interpretation. In *Travelers* (a unanimous decision), Justice Alito focused on the plain meaning of §502(b) and concluded that "Travelers' claim [for attorneys' fees] must be allowed under §502(b) unless it is unenforceable within the meaning of §502(b)(1)."[15] The Court recently took a different approach in *Marrama v. Citizens Bank of Mass.*, a 5-4 decision construing §706(a).[16] The Court in *Marrama* held that a chapter 7 debtor does not have an absolute right to convert his or her case to chapter 13 under §706(a),[17] even though the statute provides that "[a]ny waiver of the right to convert a case under [§706(a)] is unenforceable."

Justice Alito criticized the majority opinion in *Marrama* for ignoring the plain meaning of §706(a): "Nothing in §706(a) or any other provision of the Code suggests that a bankruptcy judge has the discretion to override a debtor's exercise of the §706(a) conversion right on a ground not set out in the Code."[18] Section 706(a) does not expressly require a debtor to seek permission from the bankruptcy court to convert the case. In contrast, other sections of the Code dealing with conversion require a party in interest to request court authorization to convert a case. *See* §§1112(b), 1208(b) and (d), and 1307(c).

It is not clear, however, that the Court in *Travelers* moved back to a strict plain-meaning approach to statutory construction. At the end of the *Travelers* opinion, the Court suggested that bankruptcy policy considerations might affect its future analysis on the allowability of unsecured creditors' claims for post-petition attorneys' fees.

Unanswered Questions

The most important question *Travelers* left unanswered is whether an unsecured creditor's claim for attorneys' fees incurred post-petition is an allowed claim. The Court noted that "other principles of bankruptcy law might provide an independent basis for disallowing Travelers' claim for attorneys' fees."[19] The Court may have been considering the bankruptcy principles or policies presented by 10 law professors in their *amicus* brief in support of PG&E.[20]

One key bankruptcy policy raised by the professors in their *amicus* brief is the equality of distribution for creditors.[21] Some unsecured creditors, such as involuntary creditors (tort claimants or nonpriority governmental tax claimants), or trade creditors who lack sufficient bargaining power, are not in a position to negotiate for favorable attorney-fee provisions with the debtor. Allowing the unsecured creditors who have negotiated favorable attorney-fee provisions to recover post-petition attorneys' fees would favor those unsecured creditors over other creditors who were not able to negotiate such a provision, which violates the policy of equal distribution.[22]

[U]nsecured creditors should make sure their attorney-fee provisions are broad enough to encompass attorneys' fees incurred post-petition in the bankruptcy context.

Another bankruptcy policy is the efficient administration of chapter 11 cases.[23] Congress emphasized that point with the recently imposed time limitations on plan exclusivity and lease rejection.[24] The law professors argued that allowing unsecured creditors to recover post-petition attorneys' fees could interfere with the timely formulation of a reorganization plan because the continued accrual of post-petition fees would make it difficult to determine the universe of claims against the debtor.[25] The constant accrual of attorneys' fees would also work against the goal in a chapter 13 case of providing "real" creditors with distributions from the debtor's post-petition wages. Bankruptcy courts could get bogged down with hearing objections to claims for attorneys' fees instead of administering the "actual" bankruptcy estate.

The §506(b) Argument

11 U.S.C. §506(b) allows oversecured creditors to recover attorneys' fees. PG&E argued that §506(b), by "explicit negation," disallows attorneys' fees for unsecured creditors;[26] if §502(b) already gives all creditors, secured and unsecured, a claim for attorneys' fees to the extent allowable under state law, then it would be pointless for §506(b) to specify that oversecured creditors can also recover attorneys' fees. The law professors made a similar argument in their *amicus* brief:

> [T]he Court pointed out in *Timbers* [484 U.S. 365, 372 (1988)] that §506 has the "substantive effect of denying undersecured creditors post-petition interest on their claims" by not providing for it... Section 506...should have the same substantive effect of disallowing post-petition attorneys' fees for undersecured creditors, and by extension for wholly unsecured creditors as well.[27]

The Supreme Court refused to consider the §506(b) argument because it had granted *certiorari* solely on the validity of the *Fobian* rule and because PG&E did not raise the §506(b) issue in the lower courts.[28]

The Court might ultimately view §506(b) as irrelevant to the issue of unsecured creditors' attorneys' fees because §506(b) deals exclusively with secured claims. During oral argument, it appeared that Justices Kennedy and Ginsberg were not persuaded by PG&E's §506(b) argument.[29] But the Court has looked to non-obvious Code sections in interpreting a specific section. In *Marrama,* for example, to determine why a debtor may not qualify to be a debtor under chapter 13, the Court looked past §109(e) to §307(c), which deals with conversion or dismissal of a chapter 13 case.[30]

Conclusion

Until the Supreme Court resolves these issues, unsecured creditors should make sure their attorney-fee provisions are broad enough to encompass attorneys' fees incurred post-petition in the bankruptcy context. The unsecured creditor should also review applicable state law reasonableness standards for attorneys' fees to avoid potential claim objections. In the chapter 11 context, the attorney for an unsecured creditor may face the additional obstacle of explaining why his or her services were not duplicative of the work of an unsecured creditors' committee. ■

15 *Travelers,* 2007 WL 816795 at *5.

16 — U.S. —, 127 S.Ct. 1105 (Feb. 21, 2007).

17 127 S.Ct. 1105, 1109.

18 127 S.Ct. 1105, 1113.

19 *Travelers,* 2007 WL 816795 at *9.

20 *Amicus* Brief, 2006 WL 3805866.

21 *Howard Delivery Serv. Inc. v. Zurich Am. Ins. Co.,* — U.S. —, 126 S.Ct. 2105, 2109 (June 15, 2006).

22 A counter-argument is that creditors with contractual rights for attorneys' fees are no less entitled to receive *pro rata* distribution on account of their claim for attorneys' fees than other creditors who hold different types of unsecured claims.

23 "The Supreme Court has instructed that chapter 11 cases should be administered rapidly." *In re 50-Off Stores Inc.,* 231 B.R. 592, 596 n.2 (Bankr. W.D. Tex. 1999), *citing United Savings Ass'n of Tex. v. Timbers of Inwood Forest Assocs.,* 484 U.S. 365, 375-76 (1988).

24 *See* 11 U.S.C. §365(d)(4) and §1121(d)(1) and (2).

25 *Amicus* Brief at p. 24; *but see* 11 U.S.C. §502(c)(1) (allowing estimation of unliquidated claims).

26 2007 WL 816795 at *9.

27 *Amicus* Brief at page 8.

28 2007 WL 816795 at *9.

29 Slip Copy of Oral Argument, 2007 WL 102643 at *33 ("You have the negative inference or the *exclusio unius* argument...which I think is misplaced in this context.").

30 127 S.Ct. 1105, 1110.