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Revival of Guaranty and Recovery of Postpetition Attorney's Fees: Two for the Price of One

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Introduction

Following the U.S. Supreme Court's decision in *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*,[1] now on remand to the Ninth Circuit, the Ninth Circuit Bankruptcy Appellate Panel (BAP) jumped in and tackled the issue of unsecured claims for postpetition legal fees and the "intersection of insolvency law principles and guaranty law" in *Centre Insurance Co. v. SNTL Corp. (In re SNTL Corp.)*.[2] More specifically, *SNTL Corp.* considered the following issues: First, whether a creditor's release of a guarantor is still effective when the primary obligor's payment (creating the condition for release) is later deemed a voidable preference; and second, the issue left unresolved by *Travelers*, whether an unsecured creditor may properly include in its claim contractual attorney's fees incurred postpetition.

Factual Background of *SNTL Corp.*

While the factual background of *SNTL Corp.* is rather complicated, the facts material to the two is-

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sues resolved by the Ninth Circuit BAP are straightforward. Superior National Insurance Group (SNIG) guaranteed performance of certain obligations of affiliated insurance companies to Centre Insurance Company (Centre). Following a default, SNIG's affiliates paid $163.4 million to Centre in return for satisfaction of a $180 million debt and the release of SNIG from its guaranty. The release agreement contained a provision indicating the release could be revoked by Centre if any payments received by Centre under the agreement were later deemed voidable or preferential transfers.

Thereafter, SNIG filed Chapter 11, the Insurance Commissioner for the State of California placed the affiliates into state insolvency proceedings, and the Commissioner sued Centre seeking the $163.4 million payment under state preference laws.

Centre's proof of claim in SNIG's Chapter 11 sought in excess of $180 million and expressly referenced the Commissioner's pending suit against Centre, reserving the right to seek additional amounts if any of the $163.4 million payment was deemed void or voidable in the Commissioner's suit. Centre then settled the Commissioner's suit in return for repayment of $110 million of the $163.4 million it had received from SNIG's affiliates.

In the bankruptcy case, Centre asserted that its payment of $110 million in settlement of the Commissioner's suit revived SNIG's guaranty liability. Centre also asserted it had the right to include postpetition attorney's fees in its claim based on provisions in the release agreement and related contracts.

A trustee was appointed under SNIG's plan of reorganization and asserted four objections to Centre's proof of claim: (1) Centre's claim had been released and could not be revived absent a judicial determination that the $163.4 million payment was preferential; (2) even if such a judicial determination had been made, Centre failed to exercise its right of revocation; (3) § 502(b) of the Bankruptcy Code precluded Centre from reviving claims released prepetition; and (4) as an unsecured creditor, Centre could not assert a claim for postpetition attorney's fees.

The bankruptcy court granted the trustee's summary judgment motion, rejecting Centre's claim under the "revived" guaranty and its claim for postpetition attorney's fees. Centre appealed.

Issue No. 1: Revival of Previously Released Guaranty

Judge Dennis Montali, writing for the unanimous panel, focused the decision primarily on an analysis of §§ 502 and 506. Noting the lack of Ninth Circuit authority on point and reviewing authorities from the Tenth Circuit and recognized treatises, the Ninth Circuit BAP held:

> [W]e agree that the return of a preferential payment by a creditor generally revives the liability of a guarantor.
>
> As the Tenth Circuit has observed (in dicta), courts "have recognized, without regard to any special guaranty language, that guarantors must make good on their guaranties following avoidance of payments previously made by their principal debtors." *Lowrey v. Mfrs. Hanover Leasing Corp. (In re Robinson Drilling, Inc.),* 6 F.3d 701, 704 (10th Cir. 1993). "Although a surety usually is discharged by payment of the debt, he continues to be liable if the payment constitutes a preference under bankruptcy law. A preferential payment is deemed by law to be no payment at all." *Herman Cantor Corp. v. Cent. Fidelity Bank (In re Herman Cantor Corp.),* 15 B.R. 747, 750 (Bankr. E.D. Va. 1981).

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> The *Restatement (Third) of Suretyship and Guaranty* and the *Corpus Juris Secundum* on *Principal and Surety* echo these general principles.[3]

Using these general principles as a backdrop, the BAP rejected the trustee's attempt to distinguish a voluntary payment made pursuant to a settlement (as was the case with Centre's payment to the Commissioner) from an involuntary payment made pursuant to judgment or other legal duty to do so. The BAP relied upon the Sixth Circuit decision in *Wallace Hardware Co. v. Abrams*,[4] as persuasive authority that held a guarantor's obligation to pay a debt is not released when the obligee returns a payment on the debt in settlement of a preference action. According to the court, a contrary holding would discourage settlement of litigation:

> It would be a strange result, indeed, if we were to require Centre to litigate with the Commissioner to the bitter end, lose, then satisfy a judgment of at least $163.4 million before it could revive SNIG's guaranty obligation, particularly where Article X [of the release agreement] itself requires merely a finding that the Payment was subject to a preference claim. Instead, we find *Wallace Hardware's* position more persuasive because it does not require full and costly litigation but instead acknowledges that the general principle should also apply when the creditor returns at least a portion of a primary obligor's payment in settlement of a preference action.[5]

The BAP also reversed the bankruptcy court's holding that § 502(b) precluded Centre's claim because Centre's release of SNIG was still in effect as of the bankruptcy petition date. Contrary to the trustee's arguments adopted by the bankruptcy court, the BAP found Centre held "a prepetition contingent claim inasmuch as the guaranty claim was subject to revival once the state court conservatorship had begun prepetition, giving rise to a possible (and foreseen) preference action by the Commissioner."[6] Noting that the term "claim" is broadly defined under § 101(5) and includes a "contingent" right to payment, *SNTL Corp.* explained: "Centre's claim should not be disallowed merely because the removal of the contingency affecting its claim will occur postpetition, a consequence that is plainly at odds with the Bankruptcy Code."[7] Further:

> Section 502(b)(1) provides that a claim is not allowable if it is unenforceable under the applicable agreement or law "*for a reason other than because such claim is contingent or unmatured.*" 11 U.S.C. § 502(b)(1) (emphasis added). Here, the parties provided in Article X [of the release agreement] remedies for Centre in the event a court entered an order or finding that the Payment was subject to a preference claim. Upon the occurrence of that contingency or triggering event, Centre would have certain rights and claims against SNIG. Under section 502(b)(1), those contingent claims cannot be disallowed simply because the contingency occurred postpetition.[8]

Issue No. 2: Postpetition Fees of Unsecured Creditors

Prior to *Travelers*, under *Fobian v. Western Farm Credit Bank (In re Fobian),*[9] a claim for contractual attorney's fees incurred in litigation of state law issues was not allowable—in contrast to a claim for contractual attorney's fees incurred in litigation of federal bankruptcy law issues. In *Travelers*, the Supreme Court resolved the conflict between *Fobian* and decisions of other circuits by overruling *Fobian*. However, the Supreme Court declined to determine whether § 506(b) or any other provision of the Bankruptcy Code precluded the claim for fees, leaving the door open for continued uncertainty and inconsistent outcomes.

Subsequent to *Travelers*, the lower courts have continued to wrestle with the issue of postpetition contractual fee claims by unsecured creditors. For instance, the Bankruptcy Court for the Northern District of California in May 2007, held unsecured creditors can recover such fees if recoverable under state law.[10] In July 2007, the Bankruptcy Court for the Middle District of Florida reached the opposite conclusion.[11] In *SNTL Corp.*, the BAP noted this conflict and took the opportunity to stake its own position on the matter.

Majority and Minority Views

Prior to *Travelers,* a sizeable minority of courts permitted unsecured creditors to recover postpetition attorney's fees, when a prepetition contract al-

lowed recovery.[12] In contrast, a slight majority of courts concluded that unsecured creditors *cannot* claim postpetition fees based on several theories, including the language of § 506(b). According to the majority courts, § 506(b) is the only provision in the Bankruptcy Code allowing recovery of postpetition fees and its application is limited to oversecured creditors.[13] In *SNTL Corp.,* the Ninth Circuit BAP summarized the arguments proffered by the majority courts as follows:

> [W]hether section 506(b) operates to disallow such claims; whether section 502(b) disallows such claims because they were not fixed "as of the date of the filing of the petition;" whether the Supreme Court's decision in *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd*., 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988), precludes allowance of such claims; and whether public policy favors disallowance of such claims.[14]

Whether § 506(b) Operates to Disallow Such Claims

Some courts have found the "plain language" of § 506(b) precludes unsecured creditors from recovering postpetition fees. Because § 506(b) is considered the sole exception to the general rule that claims are to be determined as of the petition date and because § 506(b)'s application is limited to oversecured creditors, these courts reason that the omission of reference to unsecured creditors means "in all other circumstances, post-petition interest, attorneys' fees, and charges shall not be allowed."[15]

Other courts have disputed whether § 506(b) even addresses issues of allowance because its title—"Determination of Secured Status"—does not suggest a limitation on unsecured claims. If it could be read to bar unsecured claims for postpetition fees, these courts reason, § 506(b) would also bar unsecured claims for prepetition fees because the statute does not make a distinction between prepetition and postpetition fees.

SNTL Corp. agreed with the latter courts, that § 506(b) merely defines secured claims, without affecting the allowance of unsecured claims:

> [T]he allowance functions of section 506(b) and 502(b) have been incorrectly conflated. Section 502(b), which applies to claims generally, does disallow unmatured interest (*see* 11 U.S.C. § 502(b)(2)); it does not specifically disallow attorneys' fees of creditors or certain other charges. Section 506(b), on the other hand, specifies what may be included in a secured claim.[16]

Whether § 502(b) Disallows Such Claims Because They are Not Fixed as of the Petition Date

SNTL Corp. also disagreed with several courts that have rejected claims for postpetition fees because the amount cannot be calculated as of the petition date as § 502(b)(1) requires the bankruptcy court to determine the amount of the claim as of the petition date. The Ninth Circuit BAP found this approach inconsistent with the broad definition of "claim" under the Bankruptcy Code, the scope of which includes contingent and unliquidated claims. Also, according to the Ninth Circuit BAP, the execution of a prepetition agreement with a provision for attorney's fees "gives rise to a contingent, unliquidated attorney-fee claim."[17]

Whether the Supreme Court's *Timbers* Decision Precludes Allowance of Such Claims

In *Timbers*, the Supreme Court held an undersecured creditor could not recover postpetition interest because § 506(b) allows postpetition interest only to the extent there is an equity cushion. Noting that several courts cite *Timbers* as authority for rejecting claims for postpetition attorney's fees—making the analogy that postpetition interest and postpetition attorney's fees should be given the same treatment under the Bankruptcy Code—*SNTL Corp.* determined that *Timbers* does not dictate that result. Rather, § 502(b)(2) specifically disallows claims for unmatured interest, however, concluded the Ninth Circuit BAP, § 502(b) *does not* contain an analogous exclusion for unmatured attorney's fees.

Whether Public Policy Precludes Allowance of Such Claims

Finally, *SNTL Corp.* observed there are public policy rationales proffered by courts in favor of and in opposition to allowance of unsecured claims for postpetition attorney's fees. Ultimately,

the BAP found no need to reconcile the conflicting public policies:

> [W]e find that the Bankruptcy Code itself provides the answer to this issue (by not specifically disallowing 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.[18]

Conclusion

SNTL Corp. agreed with and adopted the reasoning of *Qmect*, that postpetition fees cannot be disallowed solely because a creditor's claim is unsecured. The BAP remanded to the bankruptcy court to decide whether Centre's claim is allowable under the contracts and applicable state law.

The landscape may change, or continue to evolve, when the Ninth Circuit renders its decision on remand, in *Travelers*. Until then, as one of the first appellate decisions post-*Travelers*, *SNTL Corp.* should encourage unsecured creditors to include postpetition attorney's fees in their claims when a contract or statute provides for recovery of fees.

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Research References: Norton Bankr. L. & Prac. 3d §§48:28, 52:12

West's Key Number Digest, Bankruptcy ⚿2923, 2851

Notes

1. *Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Elec. Co.*, 127 S. Ct. 1199, 167 L. Ed. 2d 178 (2007).
2. *Centre Ins. Co. v. SNTL Corp. (In re SNTL Corp.)*, 380 B.R. 204 (B.A.P. 9th Cir. 2007).
3. *In re SNTL Corp.*, 380 B.R. at 213.
4. *Wallace Hardware Co. v. Abrams*, 223 F.3d 382 (6th Cir. 2000).
5. *In re SNTL Corp.*, 380 B.R. at 215.
6. *In re SNTL Corp.*, 380 B.R. at 215.
7. *In re SNTL Corp.*, 380 B.R. at 215–16.
8. *In re SNTL Corp.*, 380 B.R. at 216 (footnote omitted).
9. *Fobian v. Western Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991), *abrogated by, Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Elec. Co.,* 127 S. Ct. 1199, 167 L. Ed. 2d 178 (2007).
10. *Qmect, Inc. v. Burlingame Capital Partners II, L. P. (In re Qmect, Inc.)*, 368 B.R. 882 (Bankr. N.D. Cal. 2007).
11. *In re Electric Mach. Enters., Inc.*, 371 B.R. 549 (Bankr. M.D. Fla. 2007).
12. *See, e.g., Martin v. Bank of Germantown (In re Martin)*, 761 F.2d 1163 (6th Cir. 1985); *United Merchs. & Mfrs., Inc. v. Equitable Life Assurance Soc'y of the U.S. (In re United Merchs. & Mfrs., Inc.)*, 674 F.2d 134 (2d Cir. 1982).
13. *See, e.g., Adams v. Zimmerman*, 73 F.3d 1164 (1st Cir. 1996); *In re Waterman*, 248 B.R. 567 (B.A.P. 8th Cir. 2000).
14. *In re SNTL Corp.*, 380 B.R. at 218.
15. *In re Electric Mach. Enters., Inc.*, 371 B.R. at 551 (citation omitted).
16. *In re SNTL Corp.*, 380 B.R. at 220.
17. *In re SNTL Corp.*, 380 B.R. at 221.
18. *In re SNTL Corp.*, 380 B.R. at 222.

A Quick Look at Two Developing Areas of Postconfirmation Jurisdiction

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A previous article in the Adviser focused on postconfirmation Chapter 11 "related to" jurisdiction.[1] This article looks at two other postconfirmation jurisdiction issues on which there has been considerable activity and no consensus: liquidating plans and retention of jurisdiction provisions.

Jurisdiction—Liquidating Plans

The Bankruptcy Code's express recognition of the legitimacy of Chapter 11 liquidating plans[2] combined with the explosion of "Chapter 363" sales—sometimes followed by liquidating plans—raise issues of authority and of jurisdiction that emanate from the lack of precision in Code § 1142(b). If liquidation occurs in a Chapter 7 case, the bankruptcy court continues seamlessly to oversee the fees of all professionals and remains the appropriate forum for resolution of a wide array of matters. In contrast, confirmation of a liquidating Chapter 11 plan marks a reduction point in bankruptcy court jurisdiction. If the plan divests property from the debtor-in-possession then there is no longer property of the estate. If the plan does not divest property, then it creates a hybrid animal. In many instances the plan contains a retention of jurisdiction provision that authorizes the court to act much