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THE BANKRUPTCY STRATEGIST

Second Circuit Affirms Slashing of Unreasonable Fees In Dismissed Involuntary Bankruptcy Case

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The U.S. Court of Appeals for the Second Circuit quietly affirmed a bankruptcy court's dismissal of an involuntary petition because the petitioners' "claims were the subject of bona fide disputes within the meaning of" Bankruptcy Code (Code) §303(b)(1) (petitioner may not hold claim that is "the subject of a bona fide dispute as to liability or amount"). *In re Navient Solutions, LLC*, 2023 WL 3487051 (2d Cir. May 17, 2023). More important, the court affirmed "the bankruptcy court's [reduced] award of a sum of $44,000 in attorneys' fees and costs" under Code §303(i)(1)(B) to the debtor, "to be paid by [the lawyer for the petitioning creditors]." The court did not dwell on the facts of this litigation, but they have major practical significance. As shown below, an involuntary bankruptcy petition is a limited, risky remedy for both creditors' counsel and debtor's counsel. The fee problems encountered by counsel for the petitioners and the putative debtor in this case provide a cautionary tale.

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Relevance

Involuntary bankruptcy exists as a remedy "for the benefit of the overall creditor body …. [I]t was not intended to redress the special grievances, no matter how legitimate, of particular creditors …." *In re Murray*, 900 F.3d 53, 59-60 (2d Cir. 2018). The Circuits have been consistent. *In re Edgar A. Reyes-Colon*, 922 F.3d 13, 15 (1st Cir. 2019) (affirmed dismissal of involuntary petition filed by only two creditors; as least three petitioners required; parties engaged in "twelve years of litigation concerning the number of [debtor's] creditors and whether he might … be placed in bankruptcy involuntarily for 'equitable' reasons."); *In re 8 Speeds 8 Inc.*, 921 F.3d 1193, 1196 (9th Cir. 2019) (dissent) ("Involuntary bankruptcy is a drastic course of action that carries significant consequences, and '[f]iling an involuntary petition should be a measure of last resort' …. [T]he fee-shifting and damages provision of [Code] §303(i) are intended to deter frivolous filings …. The Majority [in this case] holds that … a third party who appears for a debtor and successfully defends against an involuntary petition can never request that the debtor be awarded costs, a reasonable attorney's fee, or damages."); *In re Anmuth Holdings LLC*, 2019 WL

1421169, *1, *27 (Bankr. E.D.N.Y. Mar. 27, 2019) (petitioning creditors “abuse[d] the power given to [them] … to file an involuntary bankruptcy petition”; these petitions “lacked any merit”; court awarded debtors attorneys’ fees, punitive damages, retroactive dismissal of the involuntary petitions, and an injunction against future filing by petitioning creditors).

Facts

The petitioning creditors in *Navient* had asserted disputed refund claims against the debtor in their involuntary petition. When the debtor moved to dismiss the petition, the petitioners never opposed the motion and their counsel never appeared at the hearing on the motion. The bankruptcy court not only abstained under Code §305(a)(i) (abstention permitted when “interests of creditors and the debtor would be better served”), but also dismissed the petition on the merits and imposed the debtor’s “reasonable” legal fees on the lawyer for the petitioning creditor. The reasonableness of the debtor’s legal fees were the big issue, though. The district court affirmed.

The Second Circuit

The Second Circuit also affirmed. Applying an “objective test, the Second Circuit agreed with the bankruptcy court that the petitioners’ “claims [were] predicated on an untested theory of recovery subject to bona fide disputes.” 2023 WL 3487051, at * 4. According to the court, “Petitioners failed to meet their initial burden of coming forward with evidence ‘to establish a prima facie case that no bona side dispute exists’.” *Id,* quoting *In re TPG Troy, LLC*, 793 F.3d 228, 234 (2d Cir. 2015) and *In re BDC 56 LLC*, 330 F.3d. 111, 118 (2d Cir. 2003). Thus far, an unremarkable result based on the plain text of Code §303(b)(i).

But legal fees were a central part of this entire litigation, not just the appeal. The Second Circuit only acknowledged in a footnote the real reason for the appeal here. The petitioners ostensibly challenged the bankruptcy court’s decision on the merits, but, in reality, were apparently “motivated to escape the award of attorneys’ fees and costs against” their lawyer, “not to revive the Petition”. 2023 WL 3487051, at *4. n. 1.

First, the bankruptcy court had imposed the putative debtor’s legal fees only on the original petitioner’s counsel who “admitted … [to being] personally liable for any fees and expenses awarded to” the putative debtor. *In re Navient Solutions, LLC*, 627 B.R 581, 594 (Bankr. S.D.N.Y. (2021)). The lawyer’s clients were therefore not liable. Accord, *In re Rosenberg*, 779 F.3d. 1254, 1261 (11th Cir. 2015) (“de facto petitioner” who failed to sign involuntary petition liable for fees and costs).

More significant was the Second Circuit’s affirmance of the bankruptcy court’s slashing of the debtor’s legal fees for work opposing the involuntary petition: “only about 10% of its requested attorneys’ fees and costs.” 2023 WL 3487051, *4. Although the debtor was entitled to “a reasonable attorney’s fee” under Code §303(i)(1)(B), the fees sought were “not reasonable,” held the bankruptcy court, explaining its 90% reduction of legal fees in concrete terms. Navient, 627 B.R. at 585.

First, said the bankruptcy court, the debtor’s “motion to dismiss the involuntary petition was overstaffed with too many lawyers and paralegals from two law firms.” 627 B.R. at 592. “[One firm] staffed this matter with five partners, four associates and one paralegal,” when the “five partners [had] billed nearly 200 hours over a month.” Id. Second, the court found a “duplication of services between” the two law firms. “Six lawyers on [one firm’s] team (including four partners), and all three

lawyers on [another firm's] team (including one partner and one counsel) attended" the hearing on the motion to dismiss. Further, reasoned the court, "the descriptions of services" by the two firms were "insufficiently detailed." *Id.* One firm omitted the "lawyers' and paralegals' titles," with no "summary for the categories of fees." *Id.* "Critically, there [were] numerous instances of impermissible block billing, and excessive hours spent on some services, including phone conferences. [One firm] block-billed 446 hours totaling $441,235.00 — approximately 84% of the total fees requested." *Id.* In concluding, the court found that it could reduce the fees "as a practical means of trimming fat from a fee application," reasoning that a reduction was appropriate "for vagueness, inconsistencies, and other deficiencies in the [bills]." 627 B.R. at 592 – 93. In sum, the court cut the fees "for numerous vague [time] entries" and "overstaffing." *Id.* at 593. *See also*, *Zolfo, Cooper & Co. v. Sunbeam Oster Co.*, 50 F.3d 253, 259-62 (3d Cir. 1995) (fee request cut because of "excessive billing" at "high end," "duplicated effort, … too many high-level personnel, and … an incomplete fee application.").

Comment

The Second Circuit's affirmation of the bankruptcy court's fee ruling confirms the need for sound billing judgment (*i.e.*, no overstaffing, duplication, or vague time records) and careful review of all bankruptcy-related bills. But these bills are not limited to legal services rendered to trustees, examiners, committees and debtors. *Navient's* "reasonableness" standard also applies to oversecured lenders when seeking legal fees under Code §506(b) ("reasonable fees"). Other professionals (*e.g.*, accountants, financial advisors, investment bankers) working on actual-time basis have to scrutinize their time records, as do the counsel for these professionals when their "reasonable" fees are to be reimbursed by the estate. As a practical matter, "reasonableness" should be the default standard for all professionals in any context. Professionals cannot foresee every possible attack on their fees by courts, third parties or their own clients. Indeed, counsel for the debtor in *Navient* identified the potential problem here: "we prepared our invoices as we do for non-debtor clients." 627 B.R. at 592. Do today's savvy non-debtor clients accept the billing practice condemned by the *Navient* bankruptcy court? Unlikely.

Overstaffing, duplication and vague time records should never be acceptable to any client, including non-debtor clients. *See*, ABA Model Rules of Professional Conduct, Rule 1.5(a) ("A lawyer shall not … collect an unreasonable fee …."); *In re Warhol*, 124 A.D.2d 235, 236-37 (1st Dept. 1996), *leave to appeal denied*, 88 N.Y.2d 803 (1996) (non-legal services cannot be part of "legal fee"; rejected lower court's "valuation" of services when lawyer "not a specialist in the relevant field" and fee "award would compensate him at an exorbitant hourly rate."); *In re Hayes*, 183 F.3d 162, 170-71 (2d Cir. 1999) ("… the attorney-client relationship, without more, constitutes a fiduciary relationship …. [T]he attorney's fiduciary obligation extends to matters involving fee agreements."); *In re Cooperman*, 83 N.Y. 2d 465, 472 (1994) ("This unique fiduciary reliance [between attorney and client] … is imbued with ultimate trust and confidence."); *In re Young*, 91 F.3d 1367, 1372 (10th Cir. 1996) ("[C]ourts have often found the requisite trust relationship to be created by the applicable Rules of Professional Responsibility.").

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