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Update on Bankruptcy Fee Shifting

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"Each litigant [in the U.S. legal system] pays [its] own attorney's fees, win or lose, unless a statute or contract provides otherwise." *Baker Botts LLP v. ASARCO LLP*, 135 S. Ct. 2158, 2164 (2015) (6-3), quoting *Hardt v. Reliance Standard Life Ins. Co.*, 560 U.S. 242, 252-53 (2010).

A majority of the U.S. Supreme Court purported to follow this so-called "American Rule" against "fee shifting" in *ASARCO*, holding on June 15, 2015 that the Bankruptcy Code ("Code") "does not permit bankruptcy courts to award compensation for … fee-defense litigation [*i.e.*, the cost of a professional's defending against an objection to its fees]." 135 S. Ct. at 2169. Other recent bankruptcy cases, though, confirm that: 1) the Code does permit fee-shifting in specific cases; 2) courts will ignore the American Rule in the right cases; and 3) more bankruptcy fee disputes continue to be litigated.

Recent Examples

Professional fees are always important to clients and lawyers in bankruptcy cases. As the following recent decisions show, the fee-shifting debate is still alive.

Individual Creditors' Committee Member Legal Fees

Legal costs of creditors' committee members cannot be reimbursed from the debtor's estate merely because a confirmed reorganization plan classifies fees as permissive plan payments; reversing bankruptcy court, *held*, plan provisions must comply with Code § 503(b)(3)(D) for committee members to be reimbursed for legal expenses. *In re Lehman Bros. Holdings Inc.*, 508 B.R. 283 (S.D.N.Y. 2014), *motion to certify appeal denied*, 2014 WL 3408574 (S.D.N.Y. June 30, 2014).

Damages for Violation Of Bankruptcy Stay

Debtor "entitled to recover the attorney's fees reasonably incurred in opposing [lender's] appeal" from sanctions order for lender's automatic stay violation. *In re Schwartz-Tallard*, 2015 WL 5946342,*5 (9th Cir. Oct. 14, 2015) (*en banc*) (10-1).

Fees for Creditors' Substantial Contribution to Case

Section 503(b)(3)(D) of the … "Code does not divest the bankruptcy courts of authority to allow reimbursement under § 503(b) of reasonable administrative expenses of creditors whose efforts substantially benefit the bankruptcy estate and its creditors in a Chapter 7 [case]." *In re Connolly North America, LLC*, 2015 WL 5515229, *6 (6th Cir. Sept. 21, 2015) (2-1).

In each of these cases, the courts wrestled with Code provisions that arguably permitted fee shifting.

Fee Defense Litigation

To support its holding that fee-defense litigation was not compensable under the Code, the Supreme Court explained in *ASARCO* that "professional services are compensable only if they are likely to benefit a debtor's estate or are necessary to case administration." 135 S. Ct. at 2163. Without specific statutory authority for compensating fee-defense work, the Court explained that it could not depart from the American Rule. Code § 330(a)(1) provides "reasonable compensation for actual, necessary services rendered." "Time spent litigating a fee application against the … bankruptcy estate [however,] cannot be fairly described as 'labor performed for' the estate," reasoned the Court. *Id*. at 2165.

The debtor's two law firms in *ASARCO* had "successfully prosecuted fraudulent transfer claims [against the debtor's corporate parent] to recover" the debtor's valuable assets valued at between $7 and $10 billion. *In re ASARCO, LLC*, 751 F.3d 291, 293 (5th Cir. 2014). *Id*. After the court confirmed a plan paying creditors "in full," the two law firms sought" lodestar fees, expenses, a 20% fee enhancement for the entire case, plus fees and expenses for preparing and litigating their final fee applications. The reorganized debtor, now controlled by its corporate parent, challenged the fees. *Id*. at 294.

The bankruptcy court rejected the reorganized debtor's objections to the requested fees after a six-day trial, awarding the two firms their basic fees and expenses. More significant, it also provided the firms with a percentage fee enhancement (*i.e.*, a bonus) for the work they performed on the fraudulent transfer litigation, but not for the rest of the work on the case. Finally, the court authorized additional fees and expenses for the two firms' "litigation in defense of their attorneys' fee claims." The district court affirmed. *Id*.

The U.S. Court of Appeals for the Fifth Circuit affirmed the fee enhancement award, relying on Code § 330(a)(3) and the bankruptcy court's fact findings detailing the "rare and exceptional" job done by the two law firms. *Id*. But the circuit court still reversed the lower courts, denying the two firms the $5 million they spent on defending their fee claims.

The Supreme Court affirmed. Because Code § 330 contained no provision for fee defense costs, the Court held that only "services" could be compensated. Fee defense work was not a "service" to the estate." "Time spent litigating a fee application against the … bankruptcy estate cannot be fairly described as 'labor performed for' the estate." 135 S. Ct. at 2165.

Individual Creditors' Committee Member Legal Fees

The district court in *Lehman Brothers Holdings Inc*. vacated a bankruptcy court's decision allowing the debtor's estate to pay the individual legal fees of creditors' committee members under the terms of a Chapter 11 reorganization plan. The bankruptcy court had ignored the explicit statutory exclusion of professional fees for individual committee members under Code § 503(b)(4). 508 B.R. at 290; See H.R. Rep. No. 109-31, at 142 (2005) ("Expenses for attorneys or accountants incurred by individual [committee] members…are not recoverable ….."). The *Lehman* bankruptcy court had relied on an earlier decision permitting the debtors in another case to reimburse the legal fees of certain key creditors in order to facilitate confirmation of a reorganization plan. *In re Adelphia Communications Corp*., 441 B.R. 6 (Bankr. S.D.N.Y. 2010).

The $26 million fee award in *Lehman* was in addition to the fees separately earned by

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the committee's retained professionals. In fact, the bankruptcy court in *Lehman* conceded that the plan provision before it was meant to "circumvent" the prohibition of Code § 503(b)(4). It reasoned, though, that § 503(b)(4) does not apply to "consensual" plan payments, when those payments were part of a "spectacularly successful plan process … ." *In re Lehman Bros. Holdings, Inc.*, 487 B.R. 181, 192 (Bankr. S.D.N.Y. 2013).

The district court in *Lehman* rejected the bankruptcy court's reasoning. In its view, the parties in the case had "devised a work-around" of the Code that "smuggled in" payments to the creditors' committee members through the "back door" of a plan. 508 B.R. at 288, 291, 293. But "neither the need for flexibility in bankruptcy cases, the consensual nature of [the reorganization plan], nor a bankruptcy court's approval of a payment as 'reasonable' can justify a plan payment that is merely a back door to administrative expenses that [Code] § 503 has clearly excluded." *Id.* at 293. In vacating the bankruptcy court's fee award, the district court remanded the case with instructions that the bankruptcy court evaluate any request for fees from committee members under the more stringent "substantial contribution" standard of Code § 503(b), a remedy that the members apparently never pursued, thus ending the matter.

Legal Fees for a Lender's Willful Stay Violation

The individual debtor in *Schwartz-Tallard* obtained an award of actual damages, punitive damages and legal fees for a lender's willful violation of the automatic stay by wrongfully foreclosing on the debtor's home after bankruptcy. *Schwartz-Tallard*, 2015 WL 59446342, at *1. The lender complied with the bankruptcy court's order to reconvey title to the debtor's home, but challenged the bankruptcy court's damages award by appealing to the district court, which later upheld the award. The lender sought no further appellate review. *Id.*

The debtor then sought additional legal fees of $10,000 that she had incurred in opposing the lender's appeal. She relied on the specific language of Code § 362(k) (injured debtor may sue for "actual damages, including costs and attorneys' fees" for violations of automatic stay). The bankruptcy court, however, denied the debtor's motion because of then-applicable Ninth Circuit precedent *Sternberg v. Johnston*, 595 F.3d 937, 947 (9th Cir. 2010) (*held*, § 362(k) allows debtor to recover only those fees incurred to end the stay violation itself, *not* fees incurred to prosecute a damages action). "Thus, under *Sternberg*, once the stay violation has ended, no fees incurred after that point may be recovered." 2015 WL 5946342, at *1.

The Bankruptcy Appellate Panel reversed, holding that *Sternberg* did not bar an award of legal fees to a debtor who successfully defends a damages award on appeal. A split panel of the U.S. Court of Appeals for the Ninth Circuit affirmed in 2014. *In re Schwartz-Tallard*, 765 F.3d 1096 (9th Cir. 2014) (2-1) (lender's reconveyance of title did not end stay violation because lender continued to challenge bankruptcy court's damage award on appeal).

Finding it unnecessary "to resolve the issue that divided the three-judge panel," the *en banc* court in 2015 simply decided "to jettison *Sternberg's* erroneous interpretation of [Code] § 362(k)." *Id.* at *2. "Although the 'American Rule' usually requires parties to bear their own attorney's fees, a common-law exception to the rule permits fee awards in litigation brought to remedy willful violations of court orders." *Id.* In fact, the court explained, Congress "strengthened the remedies previously available to debtors injured by willful stay violations" when it enacted § 362(k) by making "an award of actual damages and attorney's fees mandatory … ." *Id.*

Finally, the court noted "the difficulty courts have encountered in administering" the *Sternberg* statutory reading. *Id.* at *5. Instead of dealing with "litigation over when, exactly, a stay violation actually came to an end," as *Sternberg* required, the court preferred to interpret § 362(k) "as authorizing an award of attorney's fees incurred in prosecuting an action for damages under the statute," including "fees incurred in successfully defending the judgment on appeal." *Id.*

Substantial Contribution Fee Award to Chapter 7 Creditors

Three unsecured creditors in *Connolly North America, LLC* had successfully litigated to remove the Chapter 7 trustee for "misfeasance," 2015 WL 5515229, at *1. After the successor trustee obtained a substantial settlement from his predecessor increasing the amount available in the debtor's estate, two of the successful creditors sought reimbursement of their legal fees in getting the trustee removed.

The district court affirmed the bankruptcy court's denial of the creditors' motion, reasoning that Code§ 503(b), dealing with administrative expenses, did not authorize the requested reimbursement. A split panel of the U.S. Court of Appeals for the Sixth Circuit reversed, holding that these expenses were allowable.

The lower courts in *Connolly* had agreed that "§ 503(b) would allow for reimbursement in the present case were it not for Congress' supposed signaling of a contrary intent in § 503(b)(3)(D)," which only authorizes fee reimbursement for a creditor that makes a "substantial contribution in a Chapter 9 or a Chapter 11 case." *Id.* at *3. The Sixth Circuit reversed, relying on the text of Code § 503(b). Merely because Congress failed to designate a given expense as allowable under § 503(b) does not mean "that it is excluded." *Id.* at *4. More important, "by using the term 'including' in the opening lines of the subsection, Congress [allowed] bankruptcy courts to reimburse expenses not specifically mentioned in § 503(b)'s subsections." *Id.* Moreover, "Congress … expressly instructed in [Code] § 102(3), that the term '[is] not limited.'" *Id.* at *5. In sum, Congress never excluded the type of creditor expense here from allowance in a Chapter 7 case.

The court stressed its adherence to the text of the Code. *Id.* "Failing to award administrative expenses to the rare Chapter 7 creditors who are forced by circumstances to 'tak[e] action that benefits the [bankruptcy] estate when no other party is willing or able to do so,' would deter them from participating in bankruptcy cases and proceedings, which is plainly inconsistent with the purposes of the [Code]." *Id.*

Comments

First, the Supreme Court's *ASARCO* decision will generate more litigation, for the Court conceded that a "contract" could provide for fee shifting in the context of fee-defense litigation. 135 S. Ct. at 2164. Professionals are already scrambling to include the cost of defending their fees as a reimbursable expense in their engagement letters. *See generally* B. Markell, "Loser's Lament: Caulkett and *ASARCO*," 35 *Bankr. L. Letter*, Issue 8, at 8 (Aug. 2015) (" … there are many reasons to include contractual provisions allowing [a] defense of fees clause in bankruptcy retainer agreements … . A professional's fees in hiring another professional to defend compensation has been approved as both 'actual' and 'necessary' [expenses."). But U.S. Trustees are challenging these contractual provisions as statutory evasions intended to undermine the Code.

Second, the U.S. Trustee Program will follow up its *Lehman* win with resistance. C. White and J. Sheahan, "*Lehman*: Plans Cannot Bypass the Code (Even with Consent)," 33 *ABIJ*, No. 7, at 16, 75 (July 2014) ("The USTP … does not discourage parties from entering into appropriate comprises, but any such bargaining must take place within the Code's boundaries … . U.S. trustees may object even if no economic stakeholder does … . [A]s in *Lehman*, the USTP will remain vigilant to ensure that the specific commands of Congress are not disregarded in the name of creditor consent."). (Messrs. White and Sheahan are, respectively, director of the Executive Office for U.S. Trustees and a trial attorney in the same office).

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