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Alert

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]." *Id.* 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.

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 Section 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, at *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 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, at *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's majority explained that it could not depart from the American Rule. Nevertheless, the Court conceded that a professional's "time spent preparing a fee application is compensable." *Id.* at 2167. *See* Code § 330(a)(6); 3 Collier, *Bankruptcy* ¶330.03 [16] [a], at 330-49 (16th ed. 2015).

Code Section 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. 135 S. Ct. at 2165.

The facts in *ASARCO* are important and may have affected the outcome. The debtor's corporate parent had received prior to bankruptcy "a controlling interest in" a valuable asset at a time when the debtor was in financial distress. *In re ASARCO, LLC*, 751 F.3d 291, 293 (5th Cir. 2014). Two law firms had "successfully prosecuted fraudulent transfer claims [against the parent] to recover" the debtor's valuable property interest. "The judgment against [the debtor's parent], valued at between $7 and $10 billion was the largest fraudulent transfer judgment in Chapter 11 history." After more than four years in a Chapter 11 reorganization, the debtor emerged with "little debt, $1.4 billion in cash, and a successful resolution of its environmental, asbestos and toxic tort claims." The debtor's reorganization plan provided for the payment of all creditors "in full," with the parent retaining ownership of the debtor. *Id.*

The debtor's two law firms sought in their final fee applications "lodestar fees, expenses, a 20% fee enhancement for the entire case, and fees and expenses for preparing and litigating their final fee applications." The reorganized debtor, now controlled by its corporate parent, challenged the fees, but the U.S. Trustee did not. *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. According to the court, the performance and results achieved by the two firms were "rare and exceptional," and one of the firms charged "approximately 20% below the appropriate market rate." Finally, the court authorized additional fees and expenses for the two firms' "litigation in defense of their attorneys' fee claims." *Id.* It was this last award that was the subject of the appeal in the Supreme Court.

The district court affirmed the bankruptcy court, finding "an abundance of evidence" to support the enhanced fee award. The district court also approved the award of fees to the firms for defending their fees but remanded to the bankruptcy court to determine whether any of the "court's defense-fee award related to the enhancement." *Id.* On remand, the bankruptcy court found that all of the defense-fee award was justified, a finding that the district court later affirmed.

The Fifth Circuit affirmed the fee enhancement award, relying on Code Section 330(a)(3) and the bankruptcy court's fact findings detailing the "rare and exceptional" job done by the two law firms, yielding a result that was "without question, rare and extraordinary by any possible measure." *Id.* But the Fifth Circuit still reversed the lower courts and denied the two firms the $5 million they spent on defending their fee claims.

The Supreme Court affirmed. Because Code Section 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.

The dissent, joined by three Justices, agreed "with the Government that compensation for a fee-defense work 'is properly viewed as part of a compensation for the underlying services in [a] bankruptcy'" case. *Id.* at 2169. Denying fees for this kind of work would "dilute the value of a fee award by forcing attorneys into extensive, uncompensated litigation in order to gain any fees." *Id.* at 2170, quoting *Commissioner v. Jean*, 496 U.S. 154, 162 (1990).

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 approved these payments as reasonable under Code Section 1129(a)(4) without requiring the creditors to prove a "substantial contribution" to the case under Code Section 503(b)(3). The bankruptcy court had also ignored the explicit statutory exclusion of professional fees for individual committee members under Code Section 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 bankruptcy court 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 plan proponents in *Lehman* not only relied on *Adelphia*, but also Code Sections 1123(b)(6) and 1129(a)(4), to recover $26 million of individual committee members' legal fees as an administrative expense. This $26-million fee award was in addition to the fees separately earned by 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 Section 503(b)(4). It reasoned, though, that Section 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. According to the district court, 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 short, "interested parties and bankruptcy courts … are [not] free to tweak the law to fit their preferences." *Id.* at 294. 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 Section 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 it 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.

The debtor returned to the bankruptcy court after successfully defending her damages award on appeal, seeking additional legal fees of $10,000 that she had incurred in opposing the lender's appeal. She relied on the specific language of Code Section 362(k) (injured debtor may sue for "actual damages, including costs and attorneys' fees" for violations of automatic stay). Although the bankruptcy court stated that the debtor should be entitled to her fees on appeal, it denied the debtor's motion because of then applicable Ninth Circuit precedent — *Sternberg v. Johnston*, 595 F.3d 937, 947 (9th Cir. 2010) (*held*, Section 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 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 damages 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." In fact, the court explained, Congress "strengthened the remedies previously available to debtors injured by willful stay violations" when it enacted Section 362(k) by making "an award of actual damages and attorney's fees mandatory … ." *Id.* Nothing in the Code limits "the remedy for which the fees were incurred." *Id.* at *3. Although Section 362(k) "differs from … statutes" awarding a reasonable attorney's fee to a prevailing party, "its phrasing signals an intent to permit, not preclude, an award of fees incurred in pursuing a damages recovery." By specifically and explicitly providing for "costs and attorneys' fees," Congress was clear. Prior to the enactment of Section 362(k) in 1984, "courts were already awarding debtors the attorney's fees incurred in prosecuting civil contempt proceedings," and "Congress appears to have intended to provide statutory authorization for its continuance." *Id.*

Finally, the court noted "the difficulty courts have encountered in administering" the *Sternberg* statutory reading. *Id.* at *5. "When a debtor sues under § 362(k) both for injunctive relief aimed at ending the stay violation and for damages, and the creditor does not end the violation until after litigation has ensued, *Sternberg* requires the bankruptcy court to sort out how much attorney time was devoted to ending the stay violation (recoverable) as opposed to pursuing damages (not recoverable)." Instead of dealing with "litigation over when, exactly, a stay violation actually came to an end," the court preferred to interpret Section 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 sued his predecessor and obtained a substantial settlement 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 Section 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 expressly gives a creditor who makes a "substantial contribution in a Chapter 9 or a Chapter 11 case" an administrative expense for its expenses. *Id.* at *3. According to the Sixth Circuit, though, the question was "whether the inclusion of the 'substantial contribution in a case under Chapter 9 and 11' language in subsection (b)(3)(D) negates the meaning of 'including' in the introductory provision of § 503(b) and divests bankruptcy courts of the authority to allow reimbursement of administrative expenses incurred by a Chapter 7 creditor who makes a substantial contribution to the debtor's estate." *Id.*

The Sixth Circuit construed Code Section 503(b) under established principles of statutory construction. Merely because Congress failed to designate a given expense as allowable under Section 503(b) does not mean, according to the court, "that it is excluded." *Id.* at *4. More important, "by using the term 'including' in the opening lines of the subsection, Congress built a mechanism into § 503(b) for bankruptcy courts to reimburse expenses not specifically mentioned in § 503(b)'s subsections." Instead of providing an exhaustive list of allowable expenses, "Congress anticipated that bankruptcy courts would encounter a variety of administrative expenses … warranting reimbursement, which it could then evaluate on a case-by-case basis depending on the specific facts of the case, the benefit conferred upon the bankruptcy estate and its creditors, and whether the expenses at issue were actual, necessary, and reasonable." *Id.* Moreover, "Congress deliberately inserted 'including' into the text of § 503(b) and expressly instructed, in § 102(3), that the term '[is] not limited.'" *Id.* at *5. Because Congress never excluded the type of creditor expense here from allowance in a Chapter 7 case, the court refused to find a limitation when Congress never created one. *Id.* at *6.

The court stressed its adherence to the text and "intended meaning" of the Code. "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]." To deny the creditors here reimbursement for their expenses "not only would disincentivize participation in the bankruptcy process"; it also "would impugn the fundamental notion of bankruptcy as equitable relief." *Id.*

Comments

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, a fact not litigated in *ASARCO*. But U.S. Trustees are challenging these contractual provisions as statutory evasions intended to undermine the Code. *See generally* B. Markell, "Loser's Lament: *Caulkett* and *ASARCO*," 35 Bankr. L. Letter, Issue 8, at 8 (Aug. 2015) ("[T]here 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].").

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 compromises, 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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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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