



Publications

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Supreme Court Allows Attorney's Fees for Litigating Bankruptcy Issues

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On March 20, 2007, the United States Supreme Court resolved a split among the Circuit Courts of Appeals regarding whether the Bankruptcy Code precludes unsecured creditors from recovering contract-based attorney's fees that are authorized by a pre-bankruptcy contract and incurred during the bankruptcy case while litigating issues arising under federal bankruptcy law. In *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 549 U.S. ____ (2007), the Court held that disallowance of claims that are allowable outside of bankruptcy must be based on a specific provision of the Bankruptcy Code.

In a bankruptcy case, each creditor is entitled to file a proof of claim. If no objection is filed, the claim is allowed pursuant to section 502(a) of the Bankruptcy Code. If an objection is filed, the claim is allowed unless any of the nine specific exceptions found in section 502(b) apply.^[1] When analyzing the validity of claims, the Bankruptcy Court refers to state law. Unless the Bankruptcy Code provides a specific limitation, a claim and any defense to the claim that is available outside of bankruptcy is available in bankruptcy – thus, contract provisions that are allowable under substantive nonbankruptcy law are allowable in bankruptcy.

Despite these general principles, a split among the Circuit Courts existed regarding whether an unsecured creditor could recover attorney's fees based upon a clause in a pre-bankruptcy contract where the fees were incurred post-bankruptcy while litigating federal bankruptcy issues. The Ninth Circuit had created what was known as the *Fobian* rule, which it applied in *Travelers*. The *Fobian* rule provided that attorney's fees incurred while litigating issues peculiar to federal bankruptcy law - as opposed to those involving basic contract enforcement - "will not be awarded absent bad faith or harassment by the losing party."^[2] This rule was rejected by the Fourth Circuit.

Justice Alito, writing for a unanimous Court, overruled the *Fobian* rule, finding that the rule has no support in federal bankruptcy law. This holding reversed the decision of the Ninth Circuit denying *Travelers'* claim for attorney's fees. The Court held that the Ninth Circuit erred in disallowing *Travelers'* claim^[3] on the sole basis that the fees at issue were incurred during the bankruptcy case while litigating issues involving federal bankruptcy law.^[4] The Court found that, because there is no provision expressly disallowing claims for attorney's fees incurred by creditors litigating bankruptcy issues, the Bankruptcy Code provides no basis for disallowing *Travelers'* claim on the grounds relied upon by the Ninth Circuit. The Court expressed no opinion as to whether other principles of bankruptcy law might provide an independent basis for disallowing an unsecured creditor's claim for such attorney's fees.^[5]

In addition to providing authority for a contract creditor to include post-bankruptcy attorney's fees in its claim, this decision lends itself to several practice points:

- Unsecured creditors should consider including in their contracts, specific language allocating attorney's fees incurred to pursue, protect and enforce their rights and interests under the contract.
- This decision leaves open whether unsecured creditors will be able to recover all fees that arise under federal bankruptcy law, including fees incurred to enter an appearance, file a proof of claim, and analyze and vote on a plan of reorganization, or whether they will be limited to recovering fees incurred in connection with actual litigation of a creditor's rights, such as fees incurred in adversary proceedings, claim objection proceedings, contract and lease negotiations, and other contested matters. Contract language should be drafted broadly to encompass all attorney's fees that may be incurred in a bankruptcy proceeding.
- Because the deadline for filing proofs of claim often falls relatively early in the bankruptcy case, creditors should consider including in their claims a contingent and unliquidated amount for future attorney's fees that may be incurred before the bankruptcy case is concluded or, at the very least, a reservation of rights to amend their claims in the event that subsequent attorney's fees are incurred in the bankruptcy case.

ENDNOTES

[1] The exceptions apply where the claim is unenforceable against the debtor under an agreement or applicable law; is for unmatured interest; is a property tax that exceeds the value of the estate's interest in the property; is a claim for services rendered by an insider or attorney of the debtor that exceeds the reasonable value of those services; is for certain unmatured spousal or child support obligations; is for certain lease or employment contract termination damages; results from a reduction, due to late payment,

in the amount of credit available to a debtor relating to an employment tax on income of the debtor; or involves an untimely proof of claim. 11 U.S.C. § 502(b).

[2] *In re Fobian*, 951 F.2d 1149, 1153 (9th Cir. 1991). [3] Travelers' claim for attorney's fees was based on a pre-petition indemnity agreement requiring PG&E to reimburse Travelers for attorney's fees incurred to pursue, protect and enforce Travelers' rights under that agreement.

[4] The Court noted that generally, under the American Rule, the prevailing party is not entitled to an award of attorney's fees from the losing party; however, this rule can be overcome by statute and by an enforceable contract that allocates attorney's fees, such as the indemnity agreement at issue.

[5] One such provision, which was raised belatedly by PG&E and not addressed by the Court, is section 506(b), which permits oversecured creditors to recover reasonable attorney's fees provided for under an agreement or State statute. This section, which is entitled "Determination of secured status", does not address claims of creditors who are not secured creditors and does not expressly limit or preclude an award of attorney's fees to other types of creditors.

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