From the Top

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The U.S. Supreme Court has issued two bankruptcy rulings so far in 2007. On February 21, 2007, the Court ruled in *Marrama v. Citizens Bank of Massachusetts* that a debtor who acts in bad faith in connection with filing a chapter 7 petition may forfeit the right to convert his case to a chapter 13 case. On March 20, 2007, the Court ruled in *Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co.* that the Bankruptcy Code does not prohibit a creditor's contractual claim for attorneys' fees incurred in connection with litigating the validity in bankruptcy of claims based upon the underlying contract. These rulings are briefly discussed below.

Marrama v. Citizens Bank of Massachusetts

In *Marrama*, the debtor transferred valuable residential real estate into a revocable trust in August of 2002, for no consideration, and designated himself as sole beneficiary and his girlfriend as sole trustee, all for the purpose of putting the property beyond the reach of creditors. He filed for chapter 7 protection seven months afterward. In his bankruptcy filings, the debtor acknowledged being beneficiary of the trust, but represented that his interest had no value and denied making any property transfers within the year preceding his bankruptcy filing. He also asserted that he was not entitled to any tax refunds, when, in fact, he was owed a refund exceeding $11,000. Instead of responding to the chapter 7 trustee's inquiries regarding the discrepancies, the debtor sought to convert his case to one under chapter 13. After the trustee opposed the conversion, the debtor asserted that his misstatements and omissions were

inadvertent. The bankruptcy court refused to permit the conversion because the debtor had acted in bad faith. That determination was upheld on appeal by the bankruptcy appellate panel, and the First Circuit Court of Appeals affirmed. The Supreme Court agreed to hear the case on June 12, 2006.

Section 706(a) provides that a chapter 7 debtor "may" convert to chapter 13 "at any time," language which many courts have interpreted as giving the debtor an unconditional right to convert its case from a liquidation proceeding to a chapter 13 case. Writing for the 5-4 majority, Justice John Paul Stevens noted that, although courts are virtually unanimous in holding that a debtor's pre-petition bad faith conduct may act as a bar to relief under chapter 13, some courts have suggested that even a bad-faith debtor has an absolute right to convert a chapter 7 case into a chapter 13 case, even though the case may thereafter be dismissed or immediately reconverted to chapter 7 as a consequence of the misconduct. "While other Courts of Appeals and bankruptcy appellate panels have refused to recognize any 'bad faith' exception to the conversion right created by § 706(a)," Justice Stevens wrote, "we conclude that the courts in this case correctly held that Marrama forfeited his right to proceed under Chapter 13."

Justice Stevens concluded that section 706(d) of the Bankruptcy Code, which provides that "a case may not be converted to a case under another chapter unless the debtor may be a debtor under such chapter," expressly conditions a chapter 7 debtor's right to convert on his ability to qualify as a debtor under chapter 13. "In practical effect," the justice observed, "a ruling that an individual's Chapter 13 case should be dismissed or converted to Chapter 7 because of prepetition bad-faith conduct, including fraudulent acts committed in an earlier Chapter 7

proceeding, is tantamount to a ruling that the individual does not qualify as a debtor under Chapter 13." Those who act in bad faith, Justice Stevens concluded, are not members of the class of "honest but unfortunate debtor[s]" that the bankruptcy laws were enacted to protect.

Justices Anthony M. Kennedy, David H. Souter, Ruth Bader Ginsburg, and Stephen Breyer joined the majority opinion. Justice Samuel A. Alito Jr., joined by Chief Justice John G. Roberts Jr., Justice Antonin Scalia, and Justice Clarence Thomas, filed a dissenting opinion, arguing that nothing in section 706(a) or any other provision of the Bankruptcy Code "suggests that a bankruptcy judge has the discretion to override a debtor's exercise of the § 706(a) conversion right on a ground not set out in the Code."

Travelers

Travelers Casualty & Surety Co. ("Travelers") issued a $100 million surety bond assuring payment of workers' compensation benefits to injured employees of Pacific Gas and Electric Co. ("PG&E"). PG&E executed a series of indemnity agreements in favor of Travelers in connection with the issuance of the bonds. In the indemnification agreements, PG&E promised to pay attorneys' fees incurred by Travelers in enforcing the agreements, by litigation or otherwise.

PG&E filed for chapter 11 protection on April 6, 2001. Travelers asserted a proof of claim for contingent liabilities arising under the indemnification agreements, none of which had matured at the time of the bankruptcy filing (or, as it turned out, came to mature during PG&E's chapter 11 case). Travelers also claimed a contingent right to subrogation.

PG&E objected to the claims, contending that they were disallowed by operation of sections 502(e)(1)(B) and 509(a) of the Bankruptcy Code, which, under certain circumstances, bar contingent reimbursement and contribution claims and claims for subrogation asserted by co-debtors or parties who provide security for an obligation of the debtor. Travelers ultimately acknowledged in a stipulation with PG&E that its contingent claims were invalid.

Travelers asserted, however, that it was entitled to recover legal fees incurred in prosecuting its claim from PSE&G's bankruptcy estate, as provided in the indemnity agreements. The bankruptcy court disallowed Travelers' claim in its entirety, citing *Fobian v. Western Farm Credit Bank (In re Fobian),* 951 F.2d 1149 (9th Cir. 1991), as authority for denying that portion of the claim consisting of attorneys' fees. That ruling was upheld on appeal by the district court and the Ninth Circuit.

The Supreme Court vacated the decisions below and remanded the case for additional consideration consistent with its ruling. Justice Samuel A. Alito Jr., writing for a unanimous court, explained that, under the "American rule," "the prevailing litigant is ordinarily not entitled to collect a reasonable attorneys' fee from the loser." However, he added, this default rule can be overcome either by statute or by an "enforceable contract" allocating attorneys' fees. According to Justice Alito, a contract allocating attorneys' fees that is enforceable under applicable non-bankruptcy law is enforceable in bankruptcy except if the Bankruptcy Code provides otherwise, which it does not.

Of the nine grounds for disallowing a filed claim specified in section 502(b), Justice Alito explained, only subsection (b)(1), which disallows any claim that is "unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured," could conceivably create a basis for disallowing Travelers' claim for attorneys' fees. This provision, Justice Alito wrote, is "most naturally understood" to provide that, with limited exceptions, any defense to a claim that is available outside of the bankruptcy context is also available in bankruptcy. He also explained that this reading of section 502(b) is consistent with the well-settled maxim that "[c]reditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provision of the Bankruptcy Code."

Justice Alito also examined section 502(b)(4), which expressly disallows claims for a particular category of attorneys' fees — those for services rendered to a debtor to the extent the claimed fees "excee[d] the reasonable value of such services." The existence of that provision, Justice Alito reasoned, suggests that, in its absence, a claim for such fees would be allowed in bankruptcy to the extent enforceable under state law.

In disallowing Travelers' claim for contractual attorneys' fees, Justice Alito noted, the Ninth Circuit acknowledged that, under at least certain circumstances, a "prevailing party in a bankruptcy proceeding may be entitled to any award of attorney fees in accordance with applicable state law." Even so, the Court of Appeals rejected Travelers' claim based solely on a rule of its "own creation — the so-called *Fobian* rule." In *Fobian v. Western Farm Credit Bank (In re Fobian)*, 951 F.2d 1149 (9th Cir. 1991), the Ninth Circuit Court of Appeals ruled that a

secured creditor who prevailed on an objection to confirmation of chapter 12 plan was not entitled to an award of attorney fees from the estate, despite a provision in the note for payment of fees and costs incurred in collection, because the issues litigated involved not basic contract enforcement questions, but issues peculiar to federal bankruptcy law.

Because the *Fobian* rule finds no support in federal bankruptcy law, the Supreme Court ruled, the Ninth Circuit erred in disallowing Travelers' claim for attorneys' fees. The absence of any textual support in the Bankruptcy Code, wrote Justice Alito, "is fatal for the *Fobian* rule." Consistent with the Supreme Court's previous pronouncements regarding creditors' entitlements in bankruptcy, he observed, "claims enforceable under applicable state law will be allowed in bankruptcy unless they are expressly disallowed." According to Justice Alito, neither the Ninth Circuit nor PG&E has offered any reason why that presumption is overcome because the attorneys' fees in question were incurred litigating issues of federal bankruptcy law.

Justice Alito concluded that the Bankruptcy Code does not "clearly and expressly" compel courts to follow the *Fobian* rule. In fact, he noted, the statute says nothing about unsecured claims for contractual attorneys' fees incurred in connection with litigating issues of bankruptcy law. As such, Justice Alito remarked, "[i]n light of the broad, permissive scope of § 502(b)(1), and our prior recognition that 'the character of [a contractual] obligation to pay attorney's fees presents no obstacle to enforcing it in bankruptcy,' it necessarily follows that the *Fobian* rule cannot stand."

Finally, Justice Alito declined to address PG&E's contention that, because section 506(b) expressly provides for attorneys' fees and costs as part of an oversecured creditor's allowed secured claim, the Bankruptcy Code disallows the claims of unsecured creditors for such fees, explaining that the argument was not raised in the lower courts and stating that "[w]e express no opinion with regard to whether, following the demise of the *Fobian* rule, other principles of bankruptcy law might provide an independent basis for disallowing Travelers' claim for attorney's fees."

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Marrama v. Citizens Bank of Massachusetts, 127 S.Ct. 1105 (2007).

Travelers Casualty & Surety Co. v. Pacific Gas & Electric Co., 2007 WL 816795 (Mar. 20, 2007).