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Bankruptcy Law Update

Supreme Court Affirms Creditor's Claim for "Bankruptcy-Related" Legal Fees

The United States Supreme Court has unanimously held that federal bankruptcy law does not preclude an unsecured creditor from recovering attorney's fees authorized under a prepetition contract and incurred postpetition in bankruptcy-related litigation with the debtor.

The facts of the case – *Travelers Casualty & Surety Co. of America v. Pacific Gas & Electric Co.*, 127 S. Ct. 1195 (March 20, 2007) – are straightforward. PG&E filed for chapter 11 relief in April 2001. Travelers' had previously issued a \$100 million surety bond in favor of the California Department of Industrial Relations to guarantee PG&E's payment of state workers' compensation benefits. PG&E had executed indemnity agreements in favor of Travelers which provided that PG&E would be responsible for any loss Travelers might incur relating to the bonds, including any attorney's fees incurred by Travelers in pursuing, protecting or litigating its rights in connection with the bonds.

Travelers filed a contingent claim in PG&E's chapter 11 case to protect itself should PG&E not pay any workers' compensation benefits, requiring Travelers to make payments under its bond. In response to Travelers' claim, PG&E inserted language into its disclosure statement and plan of reorganization to protect Travelers' rights to indemnity and subrogation. Travelers did not view that protection as sufficient, resulting in additional litigation between Travelers and PG&E. The parties ultimately resolved the dispute pursuant to a Bankruptcy Court-approved stipulation that provided, in relevant part, that Travelers may assert a general unsecured claim for attorneys' fees under the indemnity agreements, subject to PG&E's right to object.

Travelers subsequently filed an amended proof of claim to recover the attorneys' fees it incurred in connection with PG&E's chapter 11 case; PG&E objected, relying on the Ninth Circuit's so-called "*Fobian* rule,"¹ which provided that attorneys' fees incurred while litigating *bankruptcy* issues are unrecoverable. The Bankruptcy Court agreed with PG&E, and the District Court and Ninth Circuit Court of Appeals affirmed. The Supreme Court reversed, holding that the "*Fobian* rule" is invalid.

¹ *In re Fobian*, 951 F.2d 1149 (9th Cir. 1991).

The Supreme Court began its analysis by looking at whether there exists any specific provision of the Bankruptcy Code that would disallow Travelers’ claim for attorneys’ fees. Finding none, the Court then examined whether Travelers’ claim was enforceable under state law, the source of law that governs the substance of most creditor claims against the debtor. Again, the Court found no bar to allowance of the claim under state law.

The Ninth Circuit, on the other hand, had not considered the validity of the claim under state law or the Bankruptcy Code. Instead, the Ninth Circuit, relying on *Fobian*, disallowed the claim because, in its view, “attorney fees are not recoverable in bankruptcy for litigating issues ‘peculiar to federal bankruptcy law.’”² The Supreme Court dismissed the Ninth Circuit’s analysis as having no support in the Bankruptcy Code, concluding that “[t]he absence of textual support is fatal for the *Fobian* rule.”³ Given the general presumption under section 502(b) of the Bankruptcy Code that claims enforceable under applicable state law will be allowed in bankruptcy cases unless expressly disallowed, and that the Bankruptcy Code nowhere disallows unsecured, contract-based claims for attorneys’ fees incurred while litigating bankruptcy law issues, the Supreme Court reversed and, in so doing, brought to an end the *Fobian* rule.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Bankruptcy & Corporate Reorganization Department.

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² 127 S.Ct. at 1205.

³ *Id.* at 1206.