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The "Fair Contemplation" Test and Attorneys' Fees Claims: A Double-Edged Sword for Debtors and Creditors

John F. Theil
Stuart Maue; St. Louis

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On Sept. 29, 2016, the Ninth Circuit Court of Appeals affirmed [1] the district court's decision upholding the bankruptcy court's denial of a post-discharge motion for attorneys' fees. The underlying motion stemmed from pre-petition state court litigation brought by creditor against debtor. While the ruling was against the creditor, debtors should be keenly aware of the applicable law, as the Ninth Circuit's detailed opinion makes it clear that the "fair contemplation" test can cut both ways.

Background

Castellino Villas (the debtor) hired Picerne Construction Corp. (the creditor) as its general contractor to construct an apartment complex. The agreement between the parties included a standard prevailing party attorneys' fees provision. The debtor defaulted on its obligations to the creditor, and the creditor brought a pre-petition state court action against the debtor and the debtor's lender to foreclose on its mechanic's lien. The debtor subsequently filed its chapter 11 petition, and the creditor obtained stay relief to continue pursuing its state court litigation.

After confirmation of its plan and the entry of the debtor's discharge, the state court held a trial on the mechanic's lien litigation and entered a $2.6 million judgment in favor of the creditor. However, the state court refused to hear the prevailing attorneys' fee claim due to the debtor's prior bankruptcy. The creditor then filed a motion with the bankruptcy court asking it to authorize the state court to determine its post-confirmation attorneys' fees. The bankruptcy court denied the motion, and the creditor appealed.

Analysis: Creditor Pre-Petition Contingent Attorneys' Fees Are Dischargeable

The Bankruptcy Code defines a party with a contingent, unliquidated pre-petition claim for attorneys' fees as a "creditor," which may include situations similar to this case when parties enter into a contract that contains an attorneys' fees provision — even before any fees are incurred. [2] This type of contingent claim includes attorneys' fees incurred both during and after the bankruptcy case. [3]

In its analysis, the court first considered numerous statutes and cases to determine when claims for attorneys' fees are dischargeable. [4] Note, however, that the court's opinion focused on pre-petition claims, which avoided some legal inconsistencies with regard to the discharge and revival issues regarding pre-confirmation claims. [5]

In making a determination of when a pre-petition claim arose, courts use the "fair contemplation" test. Pursuant to this test, "a claim arises [pre-petition or otherwise] when a claimant *can fairly or reasonably contemplate* the claim's existence" even if the triggering event for a contingent claim has yet to occur. [6]

More specifically, when a creditor and debtor (as in this case) are engaged in pre-petition litigation pursuant to a contract containing an attorneys' fees provision, a creditor "can fairly or reasonably contemplate" a claim for attorneys' fees upon the occurrence of an "extrinsic event" (*i.e.*, if it prevails in the litigation). [7] Under this set of facts, the creditor's pre-petition claim for attorneys' fees is dischargeable in the debtor's bankruptcy *even if* the creditor incurs attorneys' fees after the debtor's discharge. [8]

Debtors, Herein Lies the Rub: Your Actions Can Cause a Contrary Finding

A creditor's right to the attorneys' fees incurred pursuant to an agreement with a debtor will not always be subject to discharge or disallowance

because of the “fair contemplation” test. In fact, the debtor’s own actions can reverse the outcome of the “fair contemplation” test. [9]

The typical facts that will alter the results are when a discharged debtor voluntarily undertakes a new course of litigation, which the *Castellino* court described as a decision to “return to the fray.” This action creates new liability for attorneys’ fees and constitutes a post-discharge cost. [10] The court analyzed a number of cases and found that where it was the debtor’s decision to “eschew the fresh start provided by bankruptcy and engage in new litigation is more akin to post-petition conduct that, by definition, was not in *the fair contemplation* of the parties prepetition.” [11] Accordingly, a debtor can be liable for these post-petition and post-discharge attorneys’ fees claims through its voluntary and affirmative actions.

Conclusion

The *Castellino* case provides a thorough analysis of the “fair contemplation” test and its application to the discharge or entitlement to contingent attorneys’ fees claims. For example, when parties engage in pre-petition litigation that could result in an award of attorneys’ fees, both can *fairly contemplate* the prevailing party moving for an award of those fees (if authorized by contract or statute, *etc.*). Therefore, pursuant to the “fair contemplation” test, a creditor’s pre-petition contingent claim for attorneys’ fees is dischargeable in bankruptcy, even if the creditor incurs fees post-petition.

Contrarily, when the pre-petition litigation is resolved in bankruptcy so that any contingent claim for attorneys’ fees against the debtor would be discharged, a court will not find a debtor’s voluntary action to commence new or re-commence old litigation post-petition to be in the “fair contemplation” of the parties pre-petition.

[1] *In re Castellino Villas A. K. F. LLC,* 836 F.3d 1028 (9th Cir. 2016).

[2] *See, e.g.*, 11 U.S.C. § 101(10); *Castellino,* 836 F.3d at 1034 (“[W]hen a creditor’s right to payment for fees exists prepetition [in a chapter 7 case], the right to payment constitutes a ‘claim,’ within the meaning of § 101 (5)(A), *albeit* an unliquidated, unmatured claim.”) (quoting *In re New Power Co.*, 313 B.R. 496, 508 (N.D. Ga. 2004)) (emphasis in original).

[3] *Castellino,* 836 F.3d at 1034.

[4] *Id.* at 1033.

[5] *Id.* at 1033 n.3 (citations omitted).

[6] *Id*. (emphasis added).

[7] *Id*.

[8] *Id.* (citations omitted).

[9] *See generally Castellino,* 836 F.3d at 1034-36 (citations omitted).

[10] *Id.* at 1035 (citing *Siegel v. Fed. Home Loan Mort. Corp.*, 143 F.3d 525, 527-533 (9th Cir. 1988) (debtor received discharge and later filed lawsuit against lender for breach of deed of trust and lost; after prevailing, lender was awarded attorneys’ fees, which were upheld on appeal)).

[11] *Id.* at 1036 (emphasis added).

American Bankruptcy Institute | 66 Canal Center Plaza, Suite 600 | Alexandria, VA 22314

Tel. (703)-739-0800 | Fax. (703) 739-1060