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Your Contingency Fee May Be at Risk if Your Client Files for Bankruptcy

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Attorneys bringing personal injury and other suits on a contingency fee basis often face bankruptcy-related issues. A defendant may be insolvent, a bankruptcy trustee may assert an insurance policy is property of a bankruptcy estate, or a bankruptcy trustee may bring a competing claim against the same defendant, as just a few examples. My bankruptcy and litigation practice includes assisting contingency-fee attorneys and their clients in managing effectively a wide range of bankruptcy and insolvency matters.

This article addresses In re CWS Enterprises, 2017 WL 4051708 (9th Cir. Sept. 14), where the Ninth Circuit Court of Appeals considered the bankruptcy court's power to review a pre-petition contingency fee agreement between an attorney and her client, who became a debtor in bankruptcy.

In CWS, putting aside a somewhat contentious background, Siller hired two law firms to represent him on a contingency basis, hiring Firm A on a 28 percent contingency and Firm B on an 8 percent contingency. Siller (and Firms A and B) prevailed in the litigation and was awarded $30.5 million.

However, Siller refused to pay the contingency fees. Siller eventually settled with Firm A, but not with Firm B. First, Siller and Firm B went to arbitration where Firm B received a ruling in its favor, finding that the full amount of Firm B's contingency fee ($2.5 million) was reasonable based on its work, hours, the risks and the need for contingency counsel to finance the litigation. A state court confirmed the award. But rather than pay Firm B, Stiller filed for a Chapter 11 bankruptcy petition.

The bankruptcy court took a "fresh look" at Firm B's claim for the full amount of its contingency fee award under Section 502(b)(4) of the Bankruptcy Code, which limits a bankruptcy debtor's attorney's pre-petition claim against a bankruptcy estate to

the “reasonable value of those services.” The bankruptcy court then rejected the contingency fee agreement percentage and applied a lodestar test (multiplying Firm B’s hours by its hourly rate), thereby allowing Firm B a fee in the amount of $440,250. This is over $2 million less than the arbitral award as confirmed by the state court.

On appeal, the Ninth Circuit rejected the bankruptcy court’s analysis, but still found that the Bankruptcy Code’s “reasonableness” test permits a bankruptcy court to reduce the attorney’s fee claim below the agreed-to contingency fee percentage amount, even if it would otherwise be allowable under state law. The Ninth Circuit adopted the arbitrator’s / state court’s award and reinstated the full $2.5 million fee to Firm B, but did so on the basis of res judicata and application of the Full Faith and Credit Act in the bankruptcy courts.

The CWS ruling highlights a material financial hazard for contingency fee lawyers, as it ruled that a bankruptcy court has the authority to reduce the contracted-for contingency fee percentage / amount if determined to exceed a “reasonable value” for the attorney’s services. Attorneys who routinely handle contingency fee matters should speak with a bankruptcy attorney when facing such issues.

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