

## CAN BANKRUPTCY LAWYERS CHARGE HIGHER BILLING RATES THAN THEIR NON-BANKRUPTCY COUNTERPARTS?

By Sidney P. Levinson  
Hennigan, Bennett & Dorman LLP<sup>1</sup>

In a recent decision of the United States Bankruptcy Court for the District of Delaware, *In re Fleming Companies, Inc.*, 304 B.R. 85 (Bankr. D. Del. 2003) (“*Fleming*”), the Court held that bankruptcy practitioners are not permitted to charge higher billing rates than non-bankruptcy lawyers in the same law firm with “similar experience” – meaning, in that case, the date of an attorney’s admission to practice law. In that case, two bankruptcy attorneys from Kirkland & Ellis (“K&E”) charged \$50 per hour more than non-bankruptcy attorneys in the same firm with “similar experience” who specialized in other non-bankruptcy areas. In reaching its decision, the Court cited to *In re Busy Beaver Building Centers, Inc.*, 19 F.3d 833, 850 (3d Cir. 1994), a decision of the Third Circuit that remains a leading case on allowance of fees in bankruptcy, as well as *In re Manoa Financial Co.*, 853 F.2d 687, 690 (9<sup>th</sup> Cir. 1988), a Ninth Circuit decision cited by the Third Circuit in *Busy Beaver*.

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<sup>1</sup>The views expressed herein are those of the author and do not necessarily reflect the views of Hennigan, Bennett & Dorman LLP.

Given the prevalence in law firms of different billing rates for bankruptcy and non-bankruptcy lawyers of “similar experience” (as that term was used in *Fleming*), the decision by the Delaware bankruptcy court has potential significant implications, and warrants review and analysis of the standard -- as set forth under the Code and applied in cases such as *Busy Beaver* and *Manoa* -- for determining the billing rates that can be charged in bankruptcy cases.

**I. THE STANDARD UNDER SECTION 330 AND THE LEADING CASES THAT HAVE APPLIED THAT PROVISION**

As always, the starting point for any analysis of bankruptcy law is the language of the Bankruptcy Code. *See United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989). Section 330(a)(3)(A)(E) provides that the reasonableness of rates is “based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.” 11 U.S.C. § 330(a)(3)(A)(E). Section 330 was enacted in response to a pre-Code decision of the Ninth Circuit, *In re Beverly Crest Convalescent Hospital, Inc.*, 548 F.2d 817 (9<sup>th</sup> Cir. 1976). In *Beverly Crest*, the Ninth Circuit held that payment of bankruptcy practitioners would be arbitrarily capped in an amount based upon a district judge’s salary. The legislative history to section 330 expressly states that

Congress sought to overrule the result in *Beverly Crest*, under the rationale that bankruptcy practitioners who enable the system to operate more smoothly and efficiently would be driven to other areas of law if their compensation was fixed at lower amounts in bankruptcy cases. Recognizing that the holding in *Beverly Crest* was penny wise and pound foolish, Congress concluded that:

[B]ankruptcy legal services are entitled to command the same competency of counsel as in other cases. In that light, the policy of [section 330] is to compensate attorneys and other professionals serving in a case under title [11] at the same rate as the attorney or other professional would be compensated for performing comparable services other than in a case under title [11]. . . . Notions of economy of the estate in fixing fees are outdated and have no place in a bankruptcy code.

124 Cong. Rec. 33,994 (Joint Explanatory Statement)(remarks of Sen. DeConcini), reprinted in 1978 U.S.C.C.A.N. 6505, 6511.

The leading cases applying section 330 of the Bankruptcy Code have held that the rates approved for bankruptcy practitioners should be market based, based on the rates charged for comparable non-bankruptcy services. In *Busy Beaver*, the Third Circuit addressed whether a law firm could seek reimbursement for paralegal services. The bankruptcy court and district court had concluded that such services were clerical in nature and thus overhead that was not compensable. The Third Circuit reversed, finding that

the lower court should have considered evidence presented by debtor's counsel that non-bankruptcy clients were generally charged for such services. *Id.* at 848.

In reaching this conclusion, the court in *Busy Beaver* adopted a market based approach under which an estate should function like a sophisticated non-bankruptcy client:

As we demonstrate below, the principal purpose of the 1978 amendments to § 330 was to compensate bankruptcy attorneys at the same level as non-bankruptcy attorneys. The clearest path to that goal is to rely on the market, subject to the modification that the court will, in practical terms, act as a surrogate for the estate, reviewing the fee application much as a sophisticated non-bankruptcy client would review a legal bill. This modification is driven by the fact that, realistically speaking, the legal market functions imperfectly in bankruptcy, as the debtor "client" and other interested parties are often unable or unwilling to contest the fees charged.

*Busy Beaver*, 19 F.3d at 848.

Many courts have emphasized the importance of looking to the market to determine rates rather than allowing the Court to do so. As stated in one decision cited favorably by the Third Circuit in *Busy Beaver*, "markets know market values better than judges do." *Id.* at 854, quoting *In re Continental Illinois Securities Litigation*, 962 F.2d 566, 570 (7th Cir.1992). In fact, the Third Circuit quoted the following language from Judge Posner's opinion in *Continental Illinois Securities Litigation*:

It is apparent what the district judge's mistake was. He thought he knew the value of the class lawyers' legal services better than the market did.... He may have been right in some ethical or philosophical sense of "value" but it is not the function of judges in fee litigation to determine the equivalent of the medieval just price. It is to determine what the lawyer would receive if he were selling his services in the market rather than being paid by court order.

*Id.* at 854 n.32, quoting *Continental Illinois Securities Litigation*, 962 F.2d at 568.

As far as determining the appropriate market rate, the Third Circuit held that of the five factors enumerated in section 330(a)(3), “the cost of comparable services factor has an overarching role to act as a guide to the value of the services rendered given their nature and extent.” *Id.* at 849. However, the court in *Busy Beaver* did not “define precisely how a bankruptcy court should verify the market rates, if any” for the services at issue. *Id.* The Third Circuit did suggest that “certainly a bankruptcy judge's experience with fee petitions and his or her expert judgment pertaining to appropriate billing practices, founded on an understanding of the legal profession, will be the starting point for any analysis.” *Id.* at 854. However, the Third Circuit made clear that such experience of the bankruptcy court was just a starting point, and that ultimately, the applicant’s burden was “to prove the market would recompense him or her for that charge.” *Id.*

In *Fleming*, the Court, citing *Busy Beaver*, held that the law firm whose fees were challenged could not charge the debtor a higher billing rate for bankruptcy attorneys than the rate charged by “their peers in other practice areas.” *Fleming*, at 12. In reaching this conclusion, the Court quoted and relied upon the following passage from *Busy Beaver*:

“Section 330(a) does not entitle debtor’s attorneys to any higher compensation than that earned by non-bankruptcy attorneys” and the Court must ensure that the applicant “exercises the same ‘billing judgment’ as do non-bankruptcy attorneys.”

*Id.* (quoting *Busy Beaver*, 19 F.3d at 855-56). Notably, that passage of *Busy Beaver* arose in the context of a discussion in which the Third Circuit emphasized that bankruptcy attorneys remain subject to the same standard of “billing judgment” as non-bankruptcy lawyers – meaning that bankruptcy lawyers must, like non-bankruptcy lawyers, review their bills and write off unproductive time.

As noted above, the Third Circuit in *Busy Beaver* cited *Manoa Financial*. There, the Ninth Circuit considered whether a bankruptcy attorney was entitled to approval of a \$100,000 bonus at the conclusion of the case. *Manoa Financial*, 853 F.2d at 690. Although finding that bankruptcy lawyers were entitled to receive compensation equal to that paid in the marketplace for “comparable non-bankruptcy services,” the Ninth Circuit concluded that bankruptcy lawyers were not entitled to compensation

in excess of that standard. *Id.* at 692. Since the bankruptcy attorneys in *Manoa Financial* had apparently charged their customary billing rates, the Court concluded that they had already been reasonably compensated for their services.

## **II. K&E’S ARGUMENTS IN RESPONSE TO THE *FLEMING* DECISION**

Judge Walrath’s decision in *Fleming* presents the following issue -- what is the proper benchmark for the “comparable non-bankruptcy services” that are to be used to determine the rate that can be charged by bankruptcy counsel? In a brief that it filed in response to the *Fleming* decision, K&E argued that the proper standard was based *not* on the billing rates of non-bankruptcy lawyers who have practiced law for a similar amount of time – as the court in *Fleming* held -- but rather the rates charged by bankruptcy lawyers when the fees are not paid with estate assets, such as an out of court restructuring or work performed for creditors and other third parties.<sup>2</sup>

K&E began with the proposition that bankruptcy lawyers are entitled to be paid market rates. Citing to *Zolfo Cooper v. Sunbeam-Oster Co., Inc.*, 50 F.3d 253, 260 (3d Cir. 1995), K&E emphasized that “[t]he baseline rule

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<sup>2</sup> See Joint Report of Kirkland & Ellis LLP and Pachulski, Stang, Ziehl, Young, Jones & Weintraub P.C. in Response to Court’s Opinion Regarding First Quarterly Interim Applications for Payment of Compensation and Reimbursement of Expenses (“K&E Brief”), Case No. 03-10945 (Bankr. D. Del.), Docket No. 5693, entered January 22, 2004.

is for firms to receive their customary rates.” *Id.* at 29. This is because, according to K&E, there is a “strong presumption” that the professional’s regular hourly rate constitutes “reasonable compensation.” *In re Meronk*, 249 B.R. 208, 213 (Bankr. 9<sup>th</sup> Cir. 2000)(quoting *Manoa Financial*, 853 F.2d at 952). Noting that the standard hourly rate is only a presumption, K&E then identified two types of evidence that the Third Circuit requires to be considered in determining the market rate:

***First:*** “the bankruptcy court should compare the costs of ‘equivalent’ practitioners of the art (including their billing structures)” and

***Second:*** the court should also compare the fee applicant’s rate to the “applicant’s billing practices with ‘equivalent’ clients.”

K&E Brief, at 29-30, citing *Busy Beaver*, 19 F.3d at 853.

Based upon that standard, K&E argued that the Delaware bankruptcy court erred in concluding that the rates of bankruptcy lawyers are subject to a cap based on the rates charged by non-bankruptcy lawyers in the same firm who have “similar experience” measured by years in practice. Instead, K&E returned to the language of section 330 – which requires compensation based upon the amount “customary compensation charged by *comparably skilled practitioners* in cases other than cases under this title.” 11 U.S.C. § 330(a)(3)(A)(E)(emphasis added). According to K&E, non-bankruptcy lawyers who have different practices and different experience are not

“comparably skilled practitioners” merely because they graduated from law school in the same year as their bankruptcy counterparts.

K&E also argued that, as a matter of common sense, the rates that bankruptcy attorneys can charge should not be dictated by the practice groups that happen to be part of the same firm. Noting that certain practice areas such as insurance defense law charge lower rates than other practice areas such as complex international tax law, K&E asserted that it would be irrational for the rates of bankruptcy lawyers to be based upon the practice groups that happen to populate a particular firm.

Finally, in its Brief, K&E examined in detail the facts and holdings of the Third Circuit in *Busy Beaver* and the Ninth Circuit in *Manoa Financial*. Starting with *Busy Beaver*, K&E made the point that the language cited by the Delaware bankruptcy court in Fleming was in fact related to a discussion of “billing judgment” in determining whether to write-off unproductive time, and not part of the earlier lengthy discussion in that case concerning whether firms could charge for paralegal services under section 330. K&E asserted that the Third Circuit, in paraphrasing the Ninth Circuit’s decision in *Manoa Financial*, omitted the term “comparable” when it stated that “Section 330(a) does not entitle debtor’s attorneys to any higher compensation than

that earned by non-bankruptcy attorneys.”<sup>3</sup> K&E blamed the omission of the term “comparable” from *Busy Beaver* for contributing to the *Fleming* decision’s reliance on the rates of “non-bankruptcy attorneys” rather than for “comparable non-bankruptcy services.”

### **III. POTENTIAL IMPLICATIONS OF THE *FLEMING* DECISION**

It is difficult to reconcile the bankruptcy court’s decision in *Fleming* with the market based standard that has emerged under *Busy Beaver* and the other cases decided under section 330 of the Bankruptcy Code. It appears that in *Fleming*, the court treated the rates of non-bankruptcy attorneys in the same firm with “similar experience” as reflective of the market. However, that does not appear to be an adequate benchmark for the value attributed to bankruptcy legal services in the marketplace. In fact, the market for bankruptcy services has evolved significantly in the twenty five years since the enactment of the Bankruptcy Code. That market does not lend itself to a single, uniform rate. Rather, rates are dictated by a multitude of factors.

One significant factor is the nature of a law firm’s bankruptcy practice, and whether that firm has a national practice focused on large

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<sup>3</sup> The actual language from *Manoa Financial* reads as follows: “we think that in enacting that section [330], Congress did not intend to authorize higher compensation than attorneys would receive for *comparable non-bankruptcy services*.” *Manoa Financial*, 853 F.2d at 690 (emphasis added).

chapter 11 proceedings, a middle market practice focused in a particular region, or a practice that is heavily concentrated on chapter 7 and 13 cases. It is not surprising that law firms that compete for business in large chapter 11 cases charge higher rates than those whose focus is on middle market or chapter 7 and 13 cases, where the demand for the specialized skills, services and prolonged, intensive effort frequently required in large and/or complex chapter 11 proceedings does not always exist.

Another important factor in determining rates charged by bankruptcy attorneys (and for that matter, non-bankruptcy attorneys) is the geographic location of the law firm. For example, the market rates for bankruptcy legal services provided by law firms based in New York City appears to be generally higher than the prevailing rate for bankruptcy legal services provided by law firms based in Honolulu. This differential is in part a function of overhead costs, but also can be attributed in large part to the nature of the cases that pending in each locale. Indeed, where complex bankruptcy cases have been filed in venues where prevailing rates are not as high as in New York or Delaware, courts have nevertheless generally awarded out of state firms fees in excess of the locally prevailing rates. *E.g.*, *In re Robertson Cos.*, 123 B.R. 616, 169 (Bankr. D.N.D. 1990); *In re*

*Frontier Airlines, Inc.*, 74 B.R. 973, 976-77 (Bankr. D. Colo. 1987), cited in *Busy Beaver*, 19 F.3d at 856 n. 35.

A third factor in determining the rates of bankruptcy attorneys is the skill of the particular lawyers. As K&E noted in its Brief, certain practitioners command higher rates that are based not on the number of years they have practiced, but rather on their skills, reputation, client development abilities, and their achievements in prior cases. In *In re Jefsaba, Inc.*, 172 B.R. 786, 798 (Bankr. E.D. Pa. 1994), the court recognized the disparity that exists among lawyers of the “same vintage”:

A comparable fee data approach is susceptible to bias depending upon the members of the sampling. Not all attorneys who graduated from law school in the same year have the same experience, knowledge, or ability and, therefore, are not readily comparable. In particular, we recognize that certain professionals and professional firms, large and small, are retained because of their experience in handling complex or specialized matters and the hourly rates of those professionals may appropriately deviate from the rates of professionals of the same vintage.

With the wide range of market rates that are charged for bankruptcy related services, it should not be surprising that a similar wide range of market rates are charged for non-bankruptcy legal services. Given that disparity, the rates charged for non-bankruptcy lawyers who happen to be in the same firm but may have an entirely different practice offer little assistance in determining the market rate for bankruptcy lawyers.

Instead, it seems that a better measure of market rates continues to be the rate customarily charged by a bankruptcy lawyer to all of his or her clients. That rate is not, of course, a perfect measure – as the Third Circuit stated in *Busy Beaver*, the legal market “functions imperfectly in bankruptcy, as the debtor ‘client’ and other interested parties are often unable or unwilling to contest the fees charged.” *Busy Beaver*, 19 F.3d at 848. However, where a bankruptcy lawyer performs work for clients other than debtors or committees, a bankruptcy lawyer’s billing rate should, and in most cases will, reflect the existing market in which the lawyer competes. If the market views the billing rate charged by bankruptcy counsel as too much above market, then the lawyer will face the choice of reducing the rate or losing clients to firms that charge more competitive rates.

While the rates of non-bankruptcy lawyers of the same vintage and from the same law firm may be of some relevance in determining an appropriate market rate, the treatment of the rates of non-bankruptcy lawyers as a ceiling on rates charged in bankruptcy cases appears to be somewhat of a throwback to the Ninth Circuit’s ruling in *Beverly Crest* – which Congress overruled when it enacted section 330 – and in any event, inconsistent with the market based approach adopted by the Third Circuit in *Busy Beaver*. If courts were to adopt the court’s ruling in *Fleming*, bankruptcy lawyers

would, in fixing their billing rates, need to consider not only the rates charged by their competitors, but also the rates charged by lawyers from other practice groups in their law firm.