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BAD FAITH FEE-SHIFTING IN FEDERAL COURTS: WHAT CONDUCT QUALIFIES?

JACOB SINGER[†]

INTRODUCTION

Under the so-called “American rule” of attorney fees, each party pays its own attorney fees, regardless of the outcome of the proceeding.¹ Federal courts, however, have always recognized numerous exceptions to the American rule, one of which is the “bad faith exception.”² The exception allows courts to order fee-shifting despite the American rule. Specifically, when one of the parties to the action has acted in extreme bad faith, it must pay its opponent’s attorney fees.³ The exception promotes justice by making the prevailing party whole.⁴ Additionally, the exception enhances judicial efficiency by minimizing the number of frivolous claims on the courts’ dockets.⁵

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¹ *Chambers v. NASCO, Inc.*, 501 U.S. 32, 45 (1991); *Hall v. Cole*, 412 U.S. 1, 4 (1973); Peter N. Cubita et al., Note, *Awards of Attorney's Fees in the Federal Courts*, 56 ST. JOHN'S L. REV. 277, 278–79 (1982). The American rule contrasts with the so-called “English rule,” which allows for attorney fees, which allows the prevailing party—subject to a few exceptions—to recover reasonable attorney fees from the losing party. See Joan Chipser, Note, *Attorney's Fees and the Federal Bad Faith Exception*, 29 HASTINGS L.J. 319, 320 (1977). Although the substance of the rule was announced in the eighteenth century, the rule’s name was not coined until the beginning of the twentieth century. See John Leubsdorf, *Toward a History of the American Rule on Attorney Fee Recovery*, 47 LAW & CONTEMP. PROBS. 9, 10–11, 27–28 (1984).

² For a complete list of the exceptions to the American rule, see *infra* note 18.

³ The bad faith exception is typically applied in this manner, but the Supreme Court has allowed for the possibility that a prevailing party that acts in bad faith can be responsible for its opponent’s fees. See *Chambers*, 501 U.S. at 53.

⁴ See *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 719 (1967); see also *infra* note 29.

⁵ See, e.g., *Crum & Forster Ins. Co. v. Goodmark Indus., Inc.*, No. 05-CV-3633, 2008 U.S. Dist. LEXIS 54757, at *10 (E.D.N.Y. July 17, 2008). This argument relies

Consider the following: A business owner intentionally started a fire—his fourth in twelve years—in his warehouse that was insured by an insurance company. After the fire destroyed his warehouse, the business owner filed an insurance claim. Among other papers, he submitted a signed statement asserting that his actions or negligence did not cause the fire. When an insurance adjuster arrived at the warehouse to assess the damage, the owner bribed the adjuster to overvalue the loss. The insurance company paid out nearly \$1 million on the fraudulent claim.

In a criminal action, a federal court convicted the owner of thirty counts relating to the series of fires he had started at his warehouse. The insurance company—realizing that its payout to the owner was based on fraud—demanded restitution from the owner. The owner refused, and the insurance company filed a claim to recoup its payment. The court awarded the insurance company nearly \$2 million on summary judgment for the return of the actual payout, prejudgment and post-judgment interest, and costs. In an effort to mitigate its litigation costs, the insurance company moved to request its attorney fees from the owner, arguing that the owner's extreme bad faith actions necessitated the litigation. This scenario played out in *Crum & Forester Insurance Co.*, where the insurance company sued for restitution after discovering the fraud. The fraud became apparent after the owner was convicted in federal court.⁶

This scenario raised some important questions: Can justice be served in such a situation absent fee-shifting? Would fee-shifting deter this wrongful conduct, thereby promoting a more constructive form of dispute resolution and a more manageable court docket?

This Note explores how the federal circuits interpret the bad faith exception differently and recommends that the exception must apply to both prelitigation and litigation conduct to serve the policies of the American rule and the bad faith exception.

on both parties acting with common sense and not continuing an action when it is clearly unwarranted. The argument, however, discounts the inexplicable reality that losing parties act with intentional bad faith, both before and during a litigation proceeding. *See id.*

⁶ This situation is substantially similar to the facts of *Crum & Forster Insurance Co.*, 2008 U.S. Dist. LEXIS 54757, at *2–5, *7–10.

Part I sets out the history underpinning the American rule. Part II sets forth the rule's bad faith exception and the policies underlying the exception. It then distinguishes the common-law bad faith exception from Rule 11 fee-shifting. Part III introduces three Supreme Court cases that have established the parameters of the bad faith exception. It then examines the varying ways in which the circuit courts have applied these cases and limited the bad faith exception to conduct occurring during certain time periods. Part IV examines the reasons the courts have given for limiting the exception and refutes them. It considers what the exception's parameters should be based on the policies behind the American rule and its bad faith exception. Finally, Part V proposes applying the bad faith exception to bad faith conduct both before and during litigation and discusses the ramifications of such a proposal.

I. HISTORY OF THE AMERICAN RULE

Originally, the United States followed the English rule with respect to fee-shifting, which required the losing party to pay the prevailing party's attorney fees. This rule had roots stretching as far back as Roman law.⁷ The English rule, however, never took root in American courts; in 1796, the Supreme Court rejected the English approach and created the American rule, which requires each party to pay its own attorney fees.⁸ The Court opined that the "general practice of the United States [was] in opposition to" the English rule.⁹ Moreover, the Court noted that "even if [the American rule is] not strictly correct in principle, it is entitled to the respect of the court, till it is changed, or modified, by statute."¹⁰

The Supreme Court has articulated two general public policies underlying the adoption of the American rule. First,

⁷ Buffy D. Lord, *Dispute Resolution on the High Seas: Aspects of Maritime Arbitration*, 8 OCEAN & COASTAL L.J. 71, 86 n.109 (2002) ("The tradition of awarding attorney's fees and costs can be traced to Roman law in which the losing party was required to pay the prevailing party's costs.")

⁸ *Arcambel v. Wiseman*, 3 U.S. (3 Dall.) 306, 306 (1796).

⁹ *Id.*

¹⁰ *Id.* The Supreme Court "has adhered to [the American rule] up to modern times. It has become a hard and fast rule of law and is as entrenched as any in the American judicial system." Chipser, *supra* note 1.

parties should not be punished for merely bringing a suit.¹¹ Second, “litigating the question of what constitutes reasonable attorney’s fees would pose substantial burdens for judicial administration.”¹²

In the late nineteenth century, after courts refused to make a common law exception to the American rule,¹³ hosts of federal and state statutes attempted to remedy the rule’s harshness by allowing fee-shifting in limited circumstances. Many courts, however, found these fee-shifting statutes unconstitutional.¹⁴ These courts and other proponents of the American rule argued that forcing a losing party to pay its opponent’s attorney fees is “a form of penalty and that a litigant should not be penalized for merely defending or prosecuting a lawsuit.”¹⁵ The burgeoning anti-American rule movement, however, advocated that “under [the American rule,] the successful party is never fully compensated because such party must pay [its] counsel fees which may be as much or more than the total recovery in the suit.”¹⁶ The American rule needed to be modified to “mak[e] plaintiffs whole,” thereby ensuring justice in the court system.¹⁷ Hence, the bad faith exception to the American rule was born.

II. THE BAD FAITH EXCEPTION

A. Generally

The bad faith exception¹⁸ “awards attorney fees against parties who litigate in bad faith, for the obvious purpose of

¹¹ See *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 718 (1967).

¹² *Id.*

¹³ See *supra* note 10 and accompanying text; see also Leubsdorf, *supra* note 1, at 26 (recognizing that courts did not make such an exception until the twentieth century).

¹⁴ See Leubsdorf, *supra* note 1, at 26. Courts regarded fee-shifting as something of a confiscatory act and avoided it unless the legislature unequivocally required it. See *id.* at 25. Some courts, therefore, allowed fee-shifting statutes only when the defendant had committed an illegal act. See *id.*

¹⁵ Chipser, *supra* note 1, at 321.

¹⁶ *Id.*

¹⁷ SHELDON W. HALPERN ET AL., COPYRIGHT: CASES AND MATERIALS 549 (1992); Chipser, *supra* note 1, at 321–22; see sources cited *infra* note 29.

¹⁸ “There are six general categories of exceptions to the ‘American rule.’ (1) Contracts; (2) Bad Faith; (3) Common Fund; (4) Substantial Benefit; (5) Contempt; and (6) Fee-shifting statutes.” David A. Root, Note, *Attorney Fee-*

deterring illegitimate behavior in the courtroom, and sometimes outside of it.”¹⁹ A bad faith attorney fee award “can be imposed only in exceptional cases and for dominating reasons of justice.”²⁰ The Supreme Court in *Hall v. Cole*²¹ adopted the bad faith exception and explained that “the underlying rationale of ‘fee shifting’ is, of course, punitive, and the essential element in triggering the award of fees is therefore the existence of ‘bad faith’ on the part of the unsuccessful litigant.”²² Moreover, the Court considered fee-shifting necessary to uphold the honor of the federal courts. “[T]ampering with the administration of justice . . . is a wrong against the institutions set up to protect and safeguard the public”²³ While American courts have generally adopted the bad faith exception, they have done so uneasily.²⁴ Similarly, although courts and legislatures have carved out various exceptions to the American rule, they have shown no desire to dispose of the rule altogether.²⁵

The policies supporting the American rule do not apply to a party that acts with extreme bad faith. The Supreme Court has articulated the policies underlying the American rule: (1) encouraging parties to “vindicate their rights”²⁶ and (2) relieving the judiciary from dedicating resources to determine “what constitutes reasonable attorney’s fees.”²⁷ These policies do

Shifting in America: Comparing, Contrasting, and Combining the “American Rule” and “English Rule,” 15 IND. INT’L & COMP. L. REV. 583, 585 (2005). Of the six, the bad faith exception is the most ambiguous. *Id.* at 586 & n.28. “In the absence of one of these equitable exceptions, however, the rule has been consistently followed for almost 200 years.” *Summit Valley Indus. v. United Bhd. of Carpenters & Joiners*, 456 U.S. 717, 721 (1982) (citing *Alyeska Pipeline Serv. Co. v. Wilderness Soc’y*, 421 U.S. 240, 249–50 (1975)).

¹⁹ Leubsdorf, *supra* note 1, at 29.

²⁰ *United States v. Standard Oil Co.*, 603 F.2d 100, 103 (9th Cir. 1979) (internal quotation marks omitted); *cf.* *Int’l Bhd. of Elec. Workers v. Foust*, 442 U.S. 42, 52 (1979) (denying punitive damages); *Flight Attendants, AFL-CIO v. Horizon Air Indus., Inc.*, 976 F.2d 541, 551 (9th Cir. 1992) (citing a policy of denying punitive damages as its rationale for denying the prevailing party its attorney fees).

²¹ 412 U.S. 1 (1973).

²² *Id.* at 5.

²³ *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238, 246 (1944), *overruled on other grounds by* *Standard Oil Co. v. United States*, 429 U.S. 17 (1976).

²⁴ Even today it exists only in the federal system and in some states, mostly by statute. *See* Leubsdorf, *supra* note 1, at 29.

²⁵ *See id.*

²⁶ *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 718 (1967).

²⁷ *Id.*

not apply to a bad faith party, which, by definition, is not merely vindicating its rights.²⁸ Moreover, important public policies argue in favor of a bad faith exception. Such policies involve “punishment of the losing party, indemnification of the prevailing party, and . . . deterrence of frivolous and bad faith litigation.”²⁹ These policies apply to a bad faith party whose actions necessarily requires deterrence and deserve punishment. Bad faith parties, therefore, deserve to be punished by paying their opponent’s attorney fees.

B. Rule 11 Is Not Enough

The bad faith exception to the American rule does not supersede Rule 11 of the Federal Rules of Civil Procedure³⁰ (“Rule 11”) because the bad faith exception’s reach is broader than Rule 11.³¹ Under Rule 11, by presenting a pleading to the

In support of the American rule, it has been argued that since litigation is at best uncertain one should not be penalized for merely defending or prosecuting a lawsuit, and that the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their opponents’ counsel. Also, the time, expense, and difficulties of proof inherent in litigating the question of what constitutes reasonable attorney’s fees would pose substantial burdens for judicial administration.

Id. (citations omitted).

²⁸ For an explanation of why the judicial administration policy—or even the deterrence policy—does not apply to a bad faith party, see *infra* Part IV.B. Notably, the primary policy supporting the American rule is the need to encourage parties to vindicate their rights. See *Fleischmann*, 386 U.S. at 718.

²⁹ Lord, *supra* note 7, at 86; see HALPERN ET AL., *supra* note 17 (finding that the rationale for awarding attorney fees to prevailing plaintiffs is to “deter[] infringement, encourag[e] colorable claims, and mak[e] plaintiffs whole”); John Yukio Gotanda, *Awarding Costs and Attorneys’ Fees in International Commercial Arbitrations*, 21 MICH. J. INT’L L. 1, 13 (1999); K.J. Greene, *Motion Picture Copyright Infringement and the Presumption of Irreparable Harm: Toward a Reevaluation of the Standard for Preliminary Injunctive Relief*, 31 RUTGERS L.J. 173, 205 (1999); Cubita et al., *supra* note 1, at 282 n.16.

³⁰ A discussion of Rule 11’s applicability is necessary because when there is bad-faith conduct in the course of litigation that could be adequately sanctioned under the Rules, *the court ordinarily should rely on the Rules rather than the inherent power*. But if in the informed discretion of the court, neither the statute nor the Rules are up to the task, the court may safely rely on its inherent power—that is, the bad faith exception. *Chambers v. NASCO, Inc.*, 501 U.S. 32, 50 (1991).

³¹ Conversely, Rule 11 is broader than the bad faith exception as it can force the “outright dismissal” of the suit and other sanctions, while the bad faith exception’s only sanction is attorney fees—but that is beyond the scope of this Note. *Chambers*, 501 U.S. at 45; see FED. R. CIV. P. 11(c)(4). A Rule 11 sanction is limited to what

court, an attorney represents—amongst other things—that the litigation “is not being presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation.”³² Should a party bring litigation for an “improper purpose,”³³ Rule 11 gives courts the authority to impose sanctions on that party. “[S]anction[s] may include nonmonetary directives[,] an order to pay a penalty into court[,] or, if imposed on motion and warranted for effective deterrence, *an order directing payment to the movant of part or all of the reasonable attorney’s fees . . . directly resulting from the violation.*”³⁴

Rule 11 is narrower than the bad faith exception in two important ways. First, the Rule’s sanction power does not have jurisdiction over acts that degrade the judicial system, such as attempts to “deprive [a] [c]ourt of jurisdiction by acts of fraud” that are “performed outside the confines of [the] court.”³⁵ Second, Rule 11 only applies to the presentation of “pleading[s], written motion[s], or other paper[s]” to the court.³⁶ The bad faith exception, on the other hand, “reach[es] more litigation abuses”³⁷ and applies to all *conduct* during litigation and perhaps even conduct that precedes the litigation.³⁸ Therefore, the bad faith

suffices to deter repetition of the conduct or comparable conduct by others similarly situated. FED. R. CIV. P. 11(c)(4).

³² FED. R. CIV. P. 11(b)(1).

³³ *Id.*

³⁴ FED. R. CIV. P. 11(c)(4) (emphasis added).

³⁵ *NASCO, Inc. v. Calcasieu TV & Radio*, 124 F.R.D. 120, 138 (W.D. La. 1989), *aff’d*, 894 F.2d 696 (5th Cir. 1990), *aff’d, sub nom., Chambers*, 501 U.S. 32.

³⁶ FED. R. CIV. P. 11(b); *In re Schaefer Salt Recovery, Inc.*, 542 F.3d 90, 97 (3d Cir. 2008) (holding that the purpose of this Rule 11 requirement is to “streamline litigation”). There is a third distinction. Courts may order Rule 11 sanctions *sua sponte*. FED. R. CIV. P. 11(c)(3) (“*On the Court’s Initiative*. On its own, the court may order an attorney, law firm, or party to show cause why conduct specifically described in the order has not violated Rule 11(b).”). On the other hand, courts cannot order common law bad faith fee-shifting absent a motion by one of the parties. *See Chambers*, 501 U.S. at 49–50. This distinction, however, is not germane to a discussion of the bad faith exception’s timeline. Moreover, whether fee-shifting can be ordered by the court *sua sponte* is usually irrelevant because parties are, if anything, overeager to request fee-shifting.

³⁷ *Kelly v. Golden*, 352 F.3d 344, 352 (8th Cir. 2003).

³⁸ This Note analyzes what timeline is subject to the bad faith exception. *See infra* Part III.

exception acts as a catch-all for bad faith conduct that is not subject to Rule 11.³⁹

C. *Bad Faith Timeline*

Although federal courts universally accept the existence of the bad faith exception, no such consensus exists regarding what constitutes the requisite bad faith conduct necessary to trigger the exception.⁴⁰ There are three distinct time periods in which bad faith can occur and possibly warrant the bad faith exception.⁴¹ Bad faith conduct can occur during the litigation, when a party obstinately refuses to recognize his opponent's clear legal right, or during the conduct that is the basis of the cause of action.⁴² All federal courts agree that bad faith conduct during the litigation itself warrants the bad faith exception.⁴³ Litigation bad faith conduct includes frivolous motions, noncompliance with court orders, an unreasonable refusal to investigate claims or take part in mediation,⁴⁴ and any other conduct intended to harass a party to the litigation.⁴⁵ Conversely, courts are divided

³⁹ See *Chambers*, 501 U.S. at 43.

⁴⁰ In other words, there is no consensus regarding which conduct is subject to the bad faith exception and its fee-shifting penalty.

⁴¹ *Shimman v. Int'l Union of Operating Eng'rs, Local 18*, 744 F.2d 1226, 1230 (6th Cir. 1984). This is subject to the individual court's interpretation of the bad faith exception's timeline.

⁴² *Id.*

⁴³ *Peterson v. Air Line Pilots Ass'n*, 622 F. Supp. 232, 238 (M.D.N.C. 1985) ("It appears universally accepted that bad faith in the conduct of the litigation itself may warrant imposition of fees, as may the bad faith maintenance of a meritless claim or defense." (emphasis added)); see also *Matthew Bender & Co. v. West Pub. Co.*, 240 F.3d 116, 125 (2d Cir. 2001), *rev'd on other grounds*, 41 F. App'x 507 (2d Cir. 2002) ("[B]ad faith in the conduct of the litigation is a valid ground for an award of [attorney] fees."); *Shimman*, 744 F.2d at 1230 ("Although the bad faith exception is firmly established in Supreme Court precedent, its limits are not precisely defined.").

⁴⁴ *Chambers*, 501 U.S. at 46 (assessing attorney fees for not complying with a court order); *Peoples Mortgage Corp. v. Kan. Bankers Sur. Co.*, 62 F. App'x 232, 239 (10th Cir. 2003) (finding attorney fees against a party who did not investigate the claim and refused mediation); *Interstate Cigar Co. v. Sterling Drug Inc.*, 655 F.2d 29, 32 (2d Cir. 1981) (affirming attorney fees for a frivolous motion). Although *Peoples Mortgage Corp.* discusses an attorney fee award under state law, it is still an example of bad faith conduct during litigation and is applicable to the federal courts as well. 62 F. App'x at 239.

⁴⁵ See *Chambers*, 501 U.S. at 46 n.10.

as to whether the bad faith exception applies to the two prelitigation time periods.⁴⁶

There are two prelitigation time periods that may give rise to the bad faith exception. The first is the time period in which the conduct underpinning the cause of action occurred.⁴⁷ This conduct encompasses most intentional acts committed by the bad faith party, including embezzlement, battery, and fraud.⁴⁸ When such conduct is carried out with extreme bad faith, some courts have found it sufficient to warrant the bad faith exception to the American rule.⁴⁹ The second prelitigation time period begins when the injured party attempts to assert its legal right and ends upon the commencement of the litigation.⁵⁰ Some circuits hold that bad faith conduct by a party during this period—that is, refusing to recognize its opponent's clear legal right—warrants the bad faith exception.⁵¹ They consider such conduct sufficient to allow for fee-shifting because the “action should have been unnecessary and was compelled by the [party's] unreasonable, obdurate obstinacy.”⁵²

⁴⁶ *Peterson*, 622 F. Supp. at 238 (“On the other hand, *some courts* will award attorney's fees for bad faith in that conduct which gave rise to the litigation itself. . . .” (emphasis added)).

⁴⁷ *Dogherra v. Safeway Stores, Inc.*, 679 F.2d 1293, 1298 (9th Cir. 1982).

⁴⁸ This was the case in the scenario described above. *See supra* text accompanying notes 5–6; *see also* *Schlein v. Smith*, 160 F.2d 22, 45 (D.C. Cir. 1947).

⁴⁹ *See id.*

⁵⁰ *Flight Attendants, AFL-CIO v. Horizon Air Indus., Inc.*, 976 F.2d 541, 550 (9th Cir. 1992); *Stolberg v. Bd. of Trs.*, 474 F.2d 485, 491 (2d Cir. 1973).

⁵¹ *See Schlein*, 160 F.2d at 45. This Note will refer to this type of conduct as the “middle” timeline.

⁵² *Stolberg*, 474 F.2d at 490 (quoting *Bradley v. Sch. Bd.*, 345 F.2d 310 (4th Cir.1965)); *see also infra* Part III.C. Of course a party's conduct can only be characterized as bad faith if there is no genuine dispute and the party still refuses to recognize it adversary's legal right. *See* *Tenants & Owners in Opp'n to Redev. v. U.S. Dep't of HUD*, 406 F. Supp. 960, 964 (N.D. Cal. 1975) (“Vigorous advocacy involves conflict and is a natural and expected by-product of litigation in our judicial system. It is *only conduct that clearly goes beyond generally accepted vigor and persistence commonly employed in our adversary system* that may be considered in determining whether sanctions should be imposed.” (emphasis added)). Said another way:

Applying the bad faith exception when there is a genuine dispute would not be consonant with the right in a free society to use the legal process nor with the main purpose of courts—to settle disputes. For example, if there is a genuine controversy as to the facts or the law, mere refusal to settle should never be considered obstinacy. There must be more.

Chipser, *supra* note 1, at 330. Moreover, the actual award is limited to the costs directly related to the bad faith party's obstinacy. *See Lipsig v. Nat'l Student Mktg. Corp.*, 633 F.2d 178, 181 n.21 (D.C. Cir. 1980) (“Obstinacy awards must be limited,

III. THE BAD FAITH EXCEPTION ACCORDING TO THE COURTS

A. *The Leading Supreme Court Cases*

The Supreme Court first ruled on which time period qualifies for the bad faith exception in 1962. In *Vaughan v. Atkinson*, the Court awarded attorney fees in a suit brought by a seaman for his employer's failure to respond to a claim for maintenance and cure.⁵³ First, the Court laid down the principle that an attorney fee award is "part of the historic equity jurisdiction of the federal courts."⁵⁴ Using this principle, the Court found that the employer callously refused to make any investigation into the seaman's claim, and "[a]s a result of that recalcitrance, [the seaman] was forced to hire a lawyer and go to court to get what was plainly owed him under laws that are centuries old."⁵⁵ Finding the employer's behavior to be "willful and persistent," the Court awarded the seaman his attorney fees.⁵⁶ The Court classified its fifty percent contingency attorney fee award as "damages suffered for [the employer's] failure to pay maintenance"⁵⁷ and therefore, a "necessary expense[]."⁵⁸

While *Vaughan's* facts fell within the middle timeline—when a party obstinately denies his opponent's clear legal right prior to

however, to payment for work and expense attributable to bad-faith endeavors.") (citing *Browning Debenture Holders' Comm. v. DASA Corp.*, 560 F.2d 1078, 1089 (2d Cir. 1977)); see also *Wright v. Jackson*, 522 F.2d 955, 958 (4th Cir. 1975).

⁵³ 369 U.S. 527, 529–30 (1962).

⁵⁴ *Id.* at 530 (quoting *Sprague v. Ticonic Nat'l Bank*, 307 U.S. 161, 164 (1939)). For more information on the courts equitable powers, see: *Hall v. Cole*, 412 U.S. 1, 4–5 (1973); *Sprague*, 307 U.S. at 164–65 & n.2; *Dodge v. Tulleys*, 144 U.S. 451, 457 (1892); *Trustees v. Greenough*, 105 U.S. 527, 535–36 (1881); Alexander B. Rotbart, Comment, *Sanctions and the Inherent Power: The Supreme Court Expands the American Rule's Bad Faith Exception for Fee Shifting*—*Chambers v. NASCO, Inc.*, 16 NOVA L. REV. 1527, 1540–41 (1992). The equity jurisdiction of the federal courts originated in the English Court of Chancery, which was empowered to allocate "the entire expenses of the litigation of one of the parties as fair justice to the other party will permit . . ." *Sprague*, 307 U.S. at 164–65 & n.1. See generally 1 J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE AS ADMINISTERED IN ENGLAND AND AMERICA §§ 57–58 (14th ed. 1918).

⁵⁵ *Vaughan*, 369 U.S. at 530–31.

⁵⁶ *Id.* at 531.

⁵⁷ *Id.*

⁵⁸ *Id.* at 530 (quoting *Cortes v. Balt. Insular Line, Inc.*, 287 U.S. 367, 371 (1932)). Despite *Vaughan* classifying its attorney fee award as "damages," eleven years later the Supreme Court reclassified the award as bad faith attorney fees. See *Hall*, 412 U.S. at 2, 4.

the start of litigation—the Court did not make any distinctions between the two prelitigation time periods in later cases as they relate to the bad faith exception.⁵⁹ Instead, the Court “recognized that attorneys’ fees may be awarded to a successful party when his opponent has acted in bad faith, vexatiously, wantonly, or for oppressive reasons.”⁶⁰

A decade later, in *Hall v. Cole*,⁶¹ the Supreme Court set forth the parameters for the bad faith exception’s timeline. There, the Court affirmed an attorney fee award for an expelled union member who regained his union membership in a suit brought under a federal statute,⁶² by noting “that ‘bad faith’ may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation.”⁶³

More recently, the Court reexamined the bad faith exception in greater detail. In *Chambers v. NASCO Inc.*,⁶⁴ Chambers—sole shareholder and director of a radio and television station—contracted to sell his station and license to the NASCO corporation.⁶⁵ When Chambers instead sold the station to a third party, NASCO sued for breach of contract.⁶⁶ During the litigation, Chambers attempted to sell his properties to a third party so that “the District Court would lack jurisdiction over the properties.”⁶⁷ Moreover, Chambers “intentionally withheld [this] information from the court.”⁶⁸ Despite being warned by the district court, Chambers “refused to allow NASCO to inspect [its]

⁵⁹ *F.D. Rich Co. v. United States*, 417 U.S. 116, 129–30 (1974). The two time periods of prelitigation conduct are: (1) the conduct underlying the claim itself and (2) the middle timeline, when a party obstinately refuses to recognize its opponent’s clear legal right. *See supra* text accompanying notes 47–50; *see also* Skehan v. Bd. of Trs. of Bloomsburg State Coll., 538 F.2d 53, 57 (3d Cir. 1976) (“[T]here is a[n] . . . exception to the American rule, which allows the recovery of fees as an element of damages for prelitigation vexation or oppression in resisting a just claim.”).

⁶⁰ *F.D. Rich Co.*, 417 U.S. at 129.

⁶¹ 412 U.S. 1 (1973).

⁶² *Id.* at 2, 4.

⁶³ *Id.* at 15.

⁶⁴ 501 U.S. 32 (1991).

⁶⁵ *Id.* at 35–36.

⁶⁶ *Id.* at 36.

⁶⁷ *Id.* at 36–37.

⁶⁸ *Id.* at 37. Chambers did more than neglect to mention the attempted sale; the court explicitly questioned him about it. *See id.*

corporate records.”⁶⁹ “Chambers [then] proceeded with ‘a series of meritless motions and pleadings and delaying actions.’ ”⁷⁰

When the district court entered judgment in favor of NASCO, Chambers appealed.⁷¹ The Court of Appeals for the Fifth Circuit “found the appeal frivolous” and therefore, imposed sanctions “and remanded the case to the district court with orders to fix the amount of appellate sanctions and to determine whether further sanctions should be imposed for the manner in which the litigation had been conducted.”⁷² The district court found that additional “sanctions were appropriate ‘for the manner in which this proceeding was conducted in the district court.’ ”⁷³ Therefore, the “[district] court imposed sanctions . . . in the form of attorney’s fees and expenses totaling \$996,644.65” for the way Chambers conducted in both the district and appellate court proceedings.⁷⁴

⁶⁹ *Id.* at 38.

⁷⁰ *Id.* (quoting *NASCO, Inc. v. Calcasieu TV & Radio, Inc.*, 124 F.R.D. 120, 138 (W.D. La. 1989)), *aff'd*, 894 F.2d 696 (5th Cir. 1990), *aff'd, sub nom.*, *Chambers v. NASCO, Inc.*, 501 U.S. 32, 50 (1991)).

⁷¹ *Id.* at 39–40.

⁷² *Id.* at 40.

⁷³ *Id.* (quoting *Calcasieu TV & Radio*, 124 F.R.D. at 123).

⁷⁴ *Id.* This amount “represented the entire amount of NASCO’s litigation costs paid to its attorneys.” *Id.* The district court examined several approaches to determine if sanctions were also appropriate for Chambers’s conduct in the district court. The court “first considered *Federal Rule of Civil Procedure 11*. It noted that the alleged sanctionable conduct was that Chambers and the other defendants had . . . ‘filed false and frivolous pleadings.’ ” *Id.* at 41 (quoting *Calcasieu TV & Radio*, 124 F.R.D. at 138). The court, however, found that the “falsity of the pleadings at issue did not become apparent until after the trial on the merits, so that it would have been impossible to assess sanctions at the time the papers were filed. Consequently, the District Court deemed *Rule 11* ‘insufficient’ for its purposes.” *Id.* (quoting *Calcasieu TV & Radio*, 124 F.R.D. at 139). The district court also “declined to impose sanctions under § 1927, both because the statute applies only to attorneys, and therefore would not reach Chambers, and because the statute was [also] not broad enough to reach ‘acts which degrade the judicial system.’ ” *Id.* at 41–42 (quoting *Calcasieu TV & Radio*, 124 F.R.D. at 139); *see* 28 U.S.C. § 1927 (2006) (“Any attorney . . . who so multiplies the proceedings in any case unreasonably and vexatiously may be required by the court to satisfy personally the excess costs, expenses, and attorneys’ fees reasonably incurred because of such conduct.”). Instead, the court used its “inherent power in imposing sanctions, stressing that ‘the wielding of that inherent power is particularly appropriate when the offending parties have practiced a fraud upon the court.’ ” *Chambers*, 501 U.S. at 42 (quoting *Calcasieu TV & Radio*, 124 F.R.D. at 139). The court’s authority to impose fee-shifting comes from its inherent power. *See supra* note 54 and accompanying text. This power is the source for the court’s authority to apply the bad faith exception

The Supreme Court, in validating the attorney fee award, discussed the little-known equity power that federal courts possess. “Because of their very potency, inherent powers must be exercised with restraint and discretion. A primary aspect of that discretion is the ability to fashion an appropriate sanction for conduct which abuses the judicial process.”⁷⁵ The Court held that “outright dismissal of a lawsuit . . . is a particularly severe sanction, yet is within the court’s discretion. Consequently, the ‘less severe sanction’ of an assessment of attorney’s fees is undoubtedly within a court’s inherent power as well.”⁷⁶ Rounding out its equity power discussion, the Court explained that “[t]he award of attorney’s fees for bad faith serves the same purpose as a remedial fine imposed for civil contempt,’ because ‘it vindicates the District Court’s authority over a recalcitrant litigant.’”⁷⁷

Finally, “[b]ased on the circumstances of this case,” the Court found “that the District Court acted within its discretion in assessing as a sanction for Chambers’ bad faith conduct the entire amount of NASCO’s attorney’s fees.”⁷⁸ The Court also noted that it “express[ed] no opinion as to whether the District Court would have had the inherent power to sanction Chambers for conduct relating to the underlying breach of contract.”⁷⁹

B. Some Early Circuit Court Cases Have Implied That the Bad Faith Exception Applies to All Prelitigation Conduct

Older cases coming out of two circuits seem to extend the bad faith exception to all conduct, even the conduct that gave rise to the substantive claims. In 1947, in *Schlein v. Smith*,⁸⁰ the D.C. Circuit affirmed fee-shifting on account of the losing party’s criminal and oppressive conduct that preceded the litigation.⁸¹

and therefore, to impose attorney fee-shifting on certain losing parties. See *Hall v. Cole*, 412 U.S. 1, 4–5 (1973).

⁷⁵ *Chambers*, 501 U.S. at 44–45 (citation omitted).

⁷⁶ *Id.* at 45 (citation omitted) (quoting *Roadway Express, Inc. v. Piper*, 447 U.S. 752, 765 (1980)).

⁷⁷ *Id.* at 53 (*Hutto v. Finney*, 437 U.S. 678, 691 (1978)).

⁷⁸ *Id.* at 55.

⁷⁹ *Id.* at 55 n.16.

⁸⁰ 160 F.2d 22 (D.C. Cir. 1947).

⁸¹ *Id.* at 25. “[I]t is an almost universally recognized rule that [attorney fees] may be recovered in cases . . . where the wrongful action complained of is characterized by some such circumstances of aggravation as willfulness,

Four years later, in *Rolax v. Atlantic Coast Line Railroad*,⁸² the Fourth Circuit affirmed an attorney fee award for individuals who were oppressed by their union *before* the litigation started.⁸³

These cases, however, are not persuasive in determining the contemporary bad faith exception timeline for several reasons. First, both cases are over a half-century old⁸⁴ and neither circuit has come out with similar holdings recently.⁸⁵ Second, whether these cases actually extend the bad faith exception to all prelitigation conduct is disputed.⁸⁶ Third, both of these cases predate the three Supreme Court cases that set forth the elements of the bad faith exception.⁸⁷

C. *The Supreme Court Cases Have Been Interpreted Differently by the Circuits*

The Sixth Circuit held that the bad faith exception is inapplicable to conduct that gives rise to the claim.⁸⁸ In *Shimman v. International Union of Operating Engineers, Local 18*, a “[d]issident” union member was assaulted at a union meeting.⁸⁹ In evaluating the union member’s request for

wantonness, malice, oppression, brutality, insult, recklessness, gross negligence, or gross fraud on the part of the defendant.” *Id.* (quoting *Ballard v. Spruill*, 74 F.2d 464, 466 (1934)).

⁸² 186 F.2d 473 (4th Cir. 1951).

⁸³ *Id.* at 481. “The Court noted that the defendant union was a powerful organization as contrasted with the insular impotency of the plaintiff members.” Chipser, *supra* note 1, at 327.

⁸⁴ *Rolax*, 186 F.2d 473 (decided in 1951); *Schlein*, 160 F.2d 22 (decided in 1947).

⁸⁵ It is unclear, however, whether these circuits had the opportunity to apply the bad faith exception to conduct giving rise to the action.

⁸⁶ Compare *Shimman v. Int’l Union of Operating Eng’rs, Local 18*, 744 F.2d 1226, 1231 (6th Cir. 1984) (holding that *Schlein* does not apply “to an attorney fee award arising from a federal statutory claim for which punitive damages are inappropriate”), and *id.* (finding the common benefit exception as the basis for *Rolax*’s attorney fee award), with *Schlein*, 160 F.2d at 25 (holding that “it was proper to award counsel fees” for the prelitigation fraud by a mortgagor), and *Straub v. Vaisman & Co.*, 540 F.2d 591, 600 (3d Cir. 1976) (holding that the fee award in *Rolax* was for “activity which formed the basis for the suit”).

⁸⁷ These cases are *Vaughan*, *Hall*, and *Chambers*. See *supra* Part III.A. The earliest of these cases, *Vaughan*, was not decided until 1962. *Vaughan v. Atkinson*, 369 U.S. 527 (1962).

⁸⁸ 744 F.2d 1226, 1233 (6th Cir. 1984).

⁸⁹ An earlier appeal discusses the facts in greater detail. See *Shimman v. Frank*, 625 F.2d 80, 85 (6th Cir. 1980), *rev’d sub nom.*, *Shimman*, 744 F.2d 1226.

attorney fees under the bad faith exception, the Sixth Circuit found that that

[t]he bad faith considered by courts construing this exception generally falls within one of three categories: (1) bad faith occurring during the course of the litigation; (2) bad faith in bringing an action or in causing an action to be brought; and (3) bad faith in the acts giving rise to the substantive claim.⁹⁰

The court then delineated which prelitigation time period is subject to the bad faith exception: “Care must be taken to distinguish a defendant’s bad faith in necessitating that an action be filed or in maintaining a defense from a defendant’s bad faith in the acts giving rise to the claim.”⁹¹

The *Shimman* Court held that the bad faith exception should not extend to conduct giving rise to the action and was not persuaded by the Supreme Court’s dicta in *Hall v. Cole*.⁹² Although *Hall*’s language supports extending the bad faith exception to the acts giving rise to the claim, the *Shimman* Court found such an interpretation unpersuasive for several reasons.⁹³ First, the court pointed out that *Hall*’s language was merely dictum, and therefore, not binding.⁹⁴ Second, the court disputed this broad interpretation of *Hall*’s language.⁹⁵ *Hall* quoted *Moore’s Federal Practice* as evidence that the bad faith exception applies only to litigation conduct.⁹⁶ This quoted passage, the *Shimman* Court noted, is preceded by the following phrase: “where an unfounded action or defense is *brought or maintained*.”⁹⁷ The court found this phrase to be evidence that the exception, as interpreted by *Moore*’s, only applies to conduct

⁹⁰ *Shimman*, 744 F.2d at 1230.

⁹¹ *Id.*

⁹² 412 U.S. 1 (1973); see *Shimman*, 744 F.2d at 1232.

⁹³ The *Shimman* Court actually mentioned four reasons for its holding, but only two of them have general application. See *Shimman*, 744 F.2d at 1232–34.

⁹⁴ See *id.* at 1232.

⁹⁵ *Id.* at 1232–33. “It is clear, however, that ‘bad faith’ may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation.” *Hall*, 412 U.S. at 15.

⁹⁶ *Hall*, 412 U.S. at 5 (“[F]ederal court[s] may award counsel fees to a successful party when his opponent has acted in bad faith, vexatiously, wantonly, or for oppressive reasons.” (quoting 6 JAMES W. MOORE ET AL., MOORE’S FEDERAL PRACTICE 1709 (2d ed. 1972)) (internal quotation marks omitted)).

⁹⁷ *Shimman*, 744 F.2d at 1233 (quoting 6 JAMES W. MOORE ET AL., MOORE’S FEDERAL PRACTICE 1709 (2d ed. 1972)) (internal quotation marks omitted).

during the litigation.⁹⁸ Therefore, the *Shimman* Court concluded, it “is clear that *Hall* did not extend the bad faith exception” to the acts giving rise to the claim.⁹⁹

Finally, the *Shimman* Court held that applying the bad faith exception to the acts giving rise to the claim defeats the rationale of the general rule that parties bear their own fees.¹⁰⁰ “[T]he American rule protects the right to go to court and litigate a non-frivolous claim or defense. The unsuccessful litigant is not penalized even when an injured party whose claim is upheld is not made completely whole because of the cost of litigation.”¹⁰¹

Other federal courts have similarly applied the bad faith exception to conduct falling within the middle timeframe—bad faith in bringing an action or causing an action to be brought. Unlike the *Shimman* Court, however, these courts have not ignored the language in *Hall* that discussed the exception’s timeline.¹⁰² For example, in *Flight Attendants, AFL-CIO v. Horizon Air Industries*,¹⁰³ a “union filed suit against Horizon under the Railway Labor Act . . . , alleging [that] Horizon had violated its duty . . . to ‘exert every reasonable effort’ to reach agreement with the union.”¹⁰⁴ The district court sided with the union and required Horizon to “cease and desist from engaging in any conduct that [was] designed to forestall an agreement.”¹⁰⁵ The court found the union was entitled to attorney fees in the amount of \$250,713.50.¹⁰⁶

⁹⁸ *Id.* at 1233 n.10.

⁹⁹ *Id.* The *Shimman* Court, therefore, held that the bad faith exception only applies to conduct during litigation and the middle timeline, but not to the conduct that gave rise to the claim. *See id.* at 1232. The court actually classified these first two reasons as one, *see id.*; however, this Note uses a more delineated classification.

¹⁰⁰ *See id.* at 1231.

¹⁰¹ *Id.* The court went onto to explain the reasoning and policy behind the bad faith exception: “The unsuccessful litigant may be penalized, however, if the litigation was not maintained in good faith. In such a case, the successful party has ordinarily suffered two wrongs: one in the events giving rise to the litigation, and another in the wrongful conduct or instigation of the litigation.” *Id.*

¹⁰² A literal reading of “‘bad faith’ may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation” calls for extending the bad faith exception to prelitigation conduct. *Hall v. Cole*, 412 U.S. 1, 15 (1973).

¹⁰³ 976 F.2d 541 (9th Cir. 1992).

¹⁰⁴ *Id.* at 543 (quoting 45 U.S.C. § 152 (2006)).

¹⁰⁵ *Id.* (quoting *Flight Attendants, AFL-CIO v. Horizon Air Indus.*, No. 89-465, 1990 U.S. Dist. LEXIS 12621, at *21 (D. Or. Aug. 13, 1990)).

¹⁰⁶ *Id.*

Upon review, the Ninth Circuit overturned the attorney fees award.¹⁰⁷ The court's holding focused on policy.¹⁰⁸ The court declined to apply the bad faith exception to prelitigation conduct to avoid "conflict with the rationale of the American rule."¹⁰⁹ Instead, it interpreted *Hall's* language as not extending the bad faith exception to all prelitigation bad faith conduct.¹¹⁰ Ultimately, the court limited *Hall's* timeline language to prelitigation conduct when the losing party obstinately denied his opponent its clear legal right.¹¹¹ The court held that *Hall* did not intend to subject such conduct to the bad faith exception.¹¹²

The Second Circuit, in multiple cases, has also held that a party's denial of its opponent's clear legal right warrants the bad faith exception. In *Stolberg v. Members of the Board of Trustees*,¹¹³ a pre-*Hall v. Cole* decision, the Second Circuit held that a college professor who was wrongly denied tenure by university officials was entitled to fee-shifting because: (1) his "constitutional rights . . . were clear"; (2) "the long course of vindication of those rights . . . should . . . have been unnecessary"; and (3) awarding fees would help foster the "future exercise of

¹⁰⁷ *See id.* at 552.

¹⁰⁸ *See id.* at 549–51.

¹⁰⁹ *Id.* at 550.

¹¹⁰ *Id.*

¹¹¹ *Id.* The court used a limited bad faith exception despite the numerous contradictory implications from previous Ninth Circuit holdings. *See Dollar Sys., Inc. v. Avcar Leasing Sys., Inc.*, 890 F.2d 165, 176 (9th Cir. 1989) (upholding an attorney award because the losing party acted in "bad faith in its conduct both prior to and during the course of the litigation"); *McQuiston v. Marsh*, 707 F.2d 1082, 1086 (9th Cir. 1983) (remanding the case to the district court to adjudicate the "factual dispute as to the bad faith, if any, of the government both before and during the course of this litigation"); *Dogherra v. Safeway Stores, Inc.*, 679 F.2d 1293, 1298 (9th Cir. 1982) (applying the bad faith exception because the defendant "pursued the action after it discovered [one of its employees had lied], particularly by bringing needless, almost frivolous motions" (emphasis added)). The court in *Flight Attendants* noted these prior cases and made efforts to reconcile them with its holding. *See* 976 F.2d at 549 nn.10–11. Significantly, the *Flight Attendants* Court did not address other Ninth Circuit cases that have held prelitigation bad faith conduct warrants the bad faith exception. *See, e.g., Transgo, Inc. v. Ajac Transmission Parts Corp.*, 768 F.2d 1001, 1026 (9th Cir. 1985) (finding the "district court appropriately awarded attorney fees" to prevailing plaintiff where defendants' "violation of [plaintiff's] trademark rights and copyrights and [defendants'] conspiracy to pass off an imitation product constituted extraordinary, malicious, wanton, and oppressive conduct" which, in turn, gave rise to litigation in question).

¹¹² *See Flight Attendants*, 976 F.2d at 549–50.

¹¹³ 474 F.2d 485 (2d Cir. 1973).

such rights at public institutions by other public employees.”¹¹⁴ The court emphasized that the professor’s employment contract was not renewed “for reasons that were found to be constitutionally improper and *which have never been seriously contested* by [the university].”¹¹⁵ The Second Circuit interprets the bad faith exception to apply to a situation where litigation was “unnecessary” and only occurred due to the losing party’s “obstinacy.”¹¹⁶

A year later, in *Class v. Norton*,¹¹⁷ decided shortly after *Hall v. Cole*, the Second Circuit again held that the middle timeline warrants the bad faith exception.¹¹⁸ Addressing *Hall*’s impact on its reasoning, the court stated: “Moreover, insofar as this standard for awarding costs and attorneys’ fees has been assimilated to bad faith, the evidence marshaled by the court sufficiently supports such a finding.”¹¹⁹

¹¹⁴ *Id.* at 490–91.

¹¹⁵ *Id.* at 490 (emphasis added).

¹¹⁶ *See id.* (“[T]he standard is whether ‘*bringing of the action should have been unnecessary and was compelled by the school board’s unreasonable, obdurate obstinacy . . .*’ Because suit clearly should have been unnecessary in this case and was compelled by defendants’ conduct, counsel fees should have been awarded.” (emphasis added) (citations omitted) (quoting *Bradley v. Sch. Bd.*, 345 F.2d 310, 321 (4th Cir. 1965)). The court did not explicitly say that prelitigation bad faith conduct is insufficient to warrant an attorney fees award. Nevertheless, the court’s entire thrust is on the losing party’s obstinacy, and it refers to this conduct as “the standard,” which implies that the conduct must occur during the time period—or the litigation itself—for fee-shifting to be appropriate. *See id.* If the court interpreted the bad faith exception differently, the original bad faith act that was the cause of the claim—the improper denial of tenure for the professor—should be acknowledged in the court’s decision to award attorney fees.

¹¹⁷ 505 F.2d 123 (2d Cir. 1974).

¹¹⁸ *Id.* at 127.

¹¹⁹ *Id.* (citations omitted). This statement was immediately preceded by the court’s declaration of the obstinacy test. *Id.* (“[T]he award of costs and attorneys’ fees . . . is warranted where bringing of the action should have been unnecessary and was compelled by . . . unreasonable, obdurate obstinacy.” (internal quotation marks omitted)).

More recently, Second Circuit district courts reiterated that the bad faith exception is applicable to the middle timeline.

It is obvious that bad faith conduct by a party prior to litigation may be part of a pattern of misconduct which carries forward into the litigation. However, it is the law that a party’s bad faith, *either prior to or during the litigation*, may be the basis for an award of attorneys’ fees under the common law rule.

Sierra Club v. U.S. Army Corps of Eng’rs, 590 F. Supp. 1509, 1514 (S.D.N.Y. 1984) (emphasis added); *see N.Y. State Teamsters Conference Pension & Ret. Fund v.*

D. Circuits That Only Apply the Bad Faith Exception to Litigation Conduct

Three circuits have limited the bad faith exception to only apply to conduct during the litigation.¹²⁰ The Eighth Circuit, relying heavily on the Supreme Court's decision in *Chambers*, held that the bad faith exception only applies to conduct during litigation.¹²¹ In *Lamb Engineering & Construction Co. v. Nebraska Public Power District*,¹²² Nebraska Public Power District ("NPPD") contracted with Lamb to upgrade its sixty-five mile transmission line.¹²³ A problem arose in that "immediately after NPPD awarded Lamb the contract, NPPD increased its original estimate of work to be performed by 80%, but refused to extend Lamb's time for performance."¹²⁴ NPPD's refusal increased Lamb's costs.¹²⁵ After inclement weather hindered Lamb's progress, NPPD invoked the contract's termination clause.¹²⁶ When NPPD refused to pay Lamb's termination costs, Lamb filed suit alleging that NPPD was responsible for its "reasonable and proper charges for termination."¹²⁷ "After a jury awarded Lamb damages," the district court granted Lamb an attorney fee award on account of NPPD's bad faith.¹²⁸

Hoh, 561 F. Supp. 687, 688–689 n.1 (N.D.N.Y. 1983) (stating that defendants were entitled to attorney fees since "plaintiff had not provided a scintilla of evidence to support its claimed violation of [the statute] and that its other arguments under that statute were wholly without merit. . . . It [was] clear . . . that [plaintiff had] brought this action in bad faith . . ." (citations omitted) (internal quotation marks omitted). At least one of these courts relied on *Hall's* dictum in determining the timeline for the exception. See *Sierra Club*, 590 F. Supp. at 1514.

¹²⁰ While this section counts the Second Circuit as a circuit that only applies the bad faith exception to litigation conduct, there are Second Circuit courts that interpret the exception more broadly. See *supra* notes 113–19 and accompanying text.

¹²¹ *Lamb Eng'g & Constr. Co. v. Neb. Pub. Power Dist.*, 103 F.3d 1422, 1436–37 (8th Cir. 1997).

¹²² 103 F.3d 1422.

¹²³ *Id.* at 1427.

¹²⁴ *Id.*

¹²⁵ *Id.* at 1427–28.

¹²⁶ *Id.* at 1428–29.

¹²⁷ *Id.* at 1429. Only two of Lamb's original three causes of action survived summary judgment, and the parties voluntarily dismissed one of the two surviving claims before trial. See *id.*

¹²⁸ *Id.* at 1430. The bad faith was either based on the jury's affirmative response to an interrogatory given to the jury by the court to "determine whether NPPD acted in bad faith in administering the contract . . . or alternatively, [based] on the district court's own finding of bad faith." *Id.*

The Eighth Circuit reversed the attorney fee award because it held that the bad faith exception applied to litigation conduct only.¹²⁹ This limited interpretation of the exception's timeline was based on the recent Supreme Court decision in *Chambers v. NASCO, Inc.*¹³⁰ In *Chambers*, the Supreme Court approved the district court's grant of attorney fees as "impos[ing] sanctions for the fraud [the defendant] perpetrated on the court and the bad faith he displayed toward both his adversary and the court throughout the course of the litigation."¹³¹ The Eighth Circuit interpreted *Chambers* as rejecting the imposition of sanctions for the defendant's breach of contract.¹³²

Likewise, the Tenth Circuit's bad faith exception allows attorney fee awards only for litigation conduct. In *Morganroth & Morganroth v. DeLorean*,¹³³ the plaintiff was granted partial summary judgment for a diversity suit to set aside a fraudulent property transfer and was also awarded attorney fees on account of the defendant's bad faith.¹³⁴ The Court of Appeals for the Tenth Circuit overturned the district court's discretionary decision to grant attorney fees.¹³⁵ "[T]he district judge expressly stated that the award of attorney's fees was not based on the conduct of the litigation. Instead, the district court made it very clear that the award was based on the underlying previous conduct which gave rise to the cause of action"¹³⁶ Instead,

¹²⁹ *Id.* at 1437.

¹³⁰ 501 U.S. 32 (1991).

¹³¹ *Chambers*, 501 U.S. at 54.

¹³² *See Lamb*, 103 F.3d at 1437. Other Eighth Circuit courts have similarly applied this version of the bad faith exception. *See, e.g., Kelly v. Golden*, 352 F.3d 344, 352 (8th Cir. 2003) ("The power to award fees is exercisable *only with respect to conduct occurring during the litigation*, not conduct that gave rise to the cause of action."); *First Nat'l Bank v. Dunham*, 471 F.2d 712, 713 (8th Cir. 1973); *see also Red Sch. House, Inc. v. Office of Econ. Opportunity*, 386 F. Supp. 1177, 1194 (D. Minn. 1974); *Chipser*, *supra* note 1, at 329.

¹³³ 213 F.3d 1301 (10th Cir. 2000).

¹³⁴ *Id.* at 1305, 1317. The plaintiff's claim was under title 28, chapter 6, section 6 of the Utah Code, which "deems a transfer fraudulent without requiring proof of actual intent to defraud" for certain questionable transfers. *Id.* at 1305.

¹³⁵ *Id.* at 1317–18. "Although generally we review a district court's award of attorneys' fees for an abuse of discretion, we review its application of the legal principles underlying the award de novo." *Id.* at 1317.

¹³⁶ *Id.* (emphasis omitted); *see also Rogler v. Standard Ins. Co.*, 30 F. App'x 909, 914 (10th Cir. 2002) ("[F]ederal district court has the inherent power to 'assess attorney's fees when a party has acted in bad faith . . .'" (quoting *Chambers*, 501 U.S. at 45); *id.* ("However, *this power only extends to 'bad faith conduct in*

the circuit court held that the bad faith exception is limited to litigation conduct. Such a holding, it believed, reflected a “clear majority” of federal courts.¹³⁷ In addition, it emphasized that “[a] defendant found liable for fraud, for instance, would automatically be guilty of bad faith with respect to the underlying cause of action, thus, abrogating the American Rule in all successful fraud actions. Such complete abrogation is not the purpose of the bad faith exception.”¹³⁸ This court surprisingly makes no mention of *Hall v. Cole*.¹³⁹

Lastly, a Second Circuit case, *Dow Chemical Pacific Ltd. v. Rascator Maritime S.A.*,¹⁴⁰ expressly limited the bad faith exception to litigation conduct.¹⁴¹ “The appropriate focus for the court in applying the bad-faith exception to the American rule is the conduct of the party *in instigating or maintaining the litigation*, for an assessment of whether there has been substantive bad faith . . . or procedural bad faith”¹⁴²

litigation.’” (emphasis added) (quoting *Morganroth*, 213 F.3d at 1317)); *Ryan v. Hatfield*, 578 F.2d 275, 277 (10th Cir. 1978) (“A situation in which attorney’s fees are permissible is where the opponent in litigation has acted ‘in bad faith’” (citations omitted) (quoting *Hall v. Cole*, 412 U.S. 1, 5 (1973)). The court also referenced its earlier opinions. “We have held that this is beyond the district court’s inherent powers in federal litigation.” *Morganroth*, 213 F.3d at 1317 (citations omitted). Although the court was sitting in diversity, it refrained from ruling whether the bad faith exception actually ruled: “We have already noted that this award could not be sustained under *Towerridge*, if federal law governed. Because . . . we conclude that Utah law does not authorize the award of fees in this case either, we need not decide which law applies.” *Id.*

¹³⁷ *Morganroth*, 213 F.3d at 1318.

¹³⁸ *Id.* (internal quotation marks omitted).

¹³⁹ *See id.*

¹⁴⁰ 782 F.2d 329 (2d Cir. 1986).

¹⁴¹ *Id.* at 345. Due to the case’s complicated fact pattern, this author just uses the case’s rule of law. *See id.* at 332–33.

¹⁴² *Id.* at 345 (emphasis added); *see Crum & Forster Ins. Co. v. Goodmark Indus.*, No. 05-CV-3633, 2008 U.S. Dist. LEXIS 54757, at *10 (E.D.N.Y. July 17, 2008) (denying attorney fees because the moving party did “not allege that the Defendants committed misconduct or acted in bad faith in relation to the present civil action before this Court”). In truth, there is an unrecognized split within the Second Circuit regarding what conduct warrants the bad faith exception. This author was a victim of the false sense of universality that *Dow Chemicals* took for granted. *Dow Chem.*, 782 F.2d at 345. After doing extensive research as part of a judicial internship, the author wrote a memo advocating fee-shifting for the insurance company of this Note’s theoretical case due to the business owner’s exceptional prelitigation bad faith. *See supra* text accompanying notes 5–6. In the meantime, United States District Court Judge Spatt issued an opinion denying the attorney fee motion—and making the author’s memo moot—basing his holding on a

IV. THE BAD FAITH EXCEPTION: HOW BROAD SHOULD IT BE?

A. *Response to the Circuits That Limit the Bad Faith Exception*

Circuit courts limiting the bad faith exception's timeline have found that applying the exception to prelitigation conduct overemphasizes the Supreme Court's dictum and contradicts the policies behind the American rule and the view of most federal courts.¹⁴³ These reasons, however, can be addressed and neutralized, thereby leaving no excuse for courts to refrain from extending the bad faith exception to all conduct, including both prelitigation time periods.

First, the Sixth Circuit in *Shimman* highlighted that *Hall's* language, which seemingly extended the bad faith exception to prelitigation conduct, was dictum¹⁴⁴ and as such should be discounted. The *Hall* Court used a quote from *Moore's Federal Practice* to support its version of the bad faith exception.¹⁴⁵ As evidence that *Moore's* only intended the exception to be applied to litigation conduct, the *Shimman* Court highlighted the passage in *Moore's* immediately preceding what *Hall* quoted—"where an unfounded action or defense is brought or maintained."¹⁴⁶

The *Shimman* reasoning discounts the fact that Supreme Court dictum is still important.¹⁴⁷ Moreover, *Hall* quoted *Moore's* for a list of the *types* of conduct that qualify for the exception and purposely omitted the text that set forth the *time periods* that

different line of Second Circuit cases. *See Crum*, 2008 U.S. Dist. LEXIS 54757, at *8–10. As both lines of cases ignored the fact that there was a dispute, disturbingly, both the *Crum* opinion and this author's memo could present their individual version of the Second Circuit's holding as universal.

¹⁴³ Some of these circuits have limited the exception to litigation, while others also apply the bad faith exception to the middle timeline—when a party refuses to recognize its opponent legal right. *See supra* Part III.C–D. All circuits whose reasoning is discussed in that Part have refused to apply the bad faith exception to the act that gave rise to the claim. *See supra* Part III.C–D.

¹⁴⁴ *See Shimman v. Int'l Union of Operating Eng'rs, Local 18*, 744 F.2d 1226, 1232 (6th Cir. 1984).

¹⁴⁵ *See id.* at 1233.

¹⁴⁶ *Id.* ("Moore's *Federal Practice* precedes the quoted words with the statement, 'where an unfounded action or defense is brought or maintained. . . .' It thus is clear that *Hall* did not extend the bad faith exception." (quoting 6 JAMES W. MOORE ET AL., *MOORE'S FEDERAL PRACTICE* 1709 (2d ed. 1972) (internal quotation marks omitted))).

¹⁴⁷ This is especially true when the court goes out of its way to set forth the elements of a common-law rule. *See Hall v. Cole*, 412 U.S. 1, 4–5 (1973).

qualify for the exception.¹⁴⁸ At the very least, the actual Supreme Court opinion¹⁴⁹ should carry more weight than the words of a treatise that it omitted.

Second, the *Shimman* Court held that applying the bad faith exception to prelitigation conduct defeats the American rule's rationale that parties bear their own fees.¹⁵⁰ Similarly, in *Morganroth*, the Tenth Circuit held that a "defendant found liable for fraud, for instance, would automatically be guilty of bad faith with respect to the underlying cause of action," and "[s]uch complete abrogation is not the purpose of the bad faith exception."¹⁵¹ The general purpose behind the American rule—as the Supreme Court highlighted—is to encourage parties to "vindicate their rights."¹⁵² This, however, does not apply to a party that acts in extreme bad faith because such actions go beyond "merely defending or prosecuting a lawsuit."¹⁵³ Since the rule's rationale is inapplicable to a party that acts in bad faith—even if such actions occur before the litigation—so too should the American rule itself be inapplicable in such situations. Accordingly, all bad faith conduct should warrant the bad faith exception.

Moreover, there are important safeguards rooted in the bad faith exception to assure the exception does not completely abrogate the American rule. First, the conduct's character must amount to *extreme* bad faith.¹⁵⁴ Second, the award must serve the purposes of justice.¹⁵⁵ Most importantly, the Tenth Circuit's

¹⁴⁸ See *id.* at 5.

¹⁴⁹ *Id.* at 15 ("It is clear, however, that 'bad faith' may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation.").

¹⁵⁰ See *Shimman*, 744 F.2d at 1231.

¹⁵¹ *Morganroth & Morganroth v. DeLorean*, 213 F.3d 1301, 1318 (10th Cir. 2000) (internal quotation marks omitted).

¹⁵² *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 718 (1967) ("Since litigation is at best uncertain one should not be penalized for merely defending or prosecuting a lawsuit . . .").

¹⁵³ *Id.*; see also *Morganroth*, 213 F.3d at 1318 (finding the American rule does not apply in fraud cases).

¹⁵⁴ See *Barry v. Bowen*, 825 F.2d 1324, 1333 (9th Cir. 1987); *Beaudry Motor Co. v. ABKO Props., Inc.*, 780 F.2d 751, 756 (9th Cir. 1986); *Cubita et al.*, *supra* note 1, at 284 ("Indeed, fee shifting under the 'bad faith' doctrine is justified only in exceptional circumstances.").

¹⁵⁵ See *Lipsig v. Nat'l Student Mktg. Corp.*, 663 F.2d 178, 180 (D.C. Cir. 1980) ("[T]he fee-shifting sanction is invocable only for some dominating reason of justice."); *United States v. Standard Oil Co.*, 603 F.2d 100, 103 (9th Cir. 1979).

reasoning is circular: If fee-shifting in all fraud cases is in line with the policies behind both the American rule and its bad faith exception, why is “[s]uch complete abrogation . . . not the purpose of the bad faith exception?”¹⁵⁶

Third, in *Flight Attendants*, the Ninth Circuit, uncomfortable with disregarding the *Hall* dictum, applied the exception to the middle timeline but not to the conduct that gave rise to the substantive claim.¹⁵⁷ Although this holding technically “fits in” with the *Hall* dictum, it overlooks the fact that *Hall* did not make any distinctions within the prelitigation time periods.¹⁵⁸ Moreover, since the policies behind the American rule do not give sufficient cause to apply the rule to any prelitigation bad faith conduct,¹⁵⁹ it is incumbent upon the courts to apply the rule’s exception to *all* prelitigation conduct.

Fourth, in *Lamb*, the Eighth Circuit limited the bad faith exception because the Supreme Court in *Chambers* awarded attorney fees only on the basis of defendant’s bad faith conduct during the litigation and not for his intentional breach of contract.¹⁶⁰ This reasoning incorrectly focuses only on the district court’s reasoning for its award. The Supreme Court, however, was only *affirming* the award, not granting it.¹⁶¹ The Court was merely abiding by the district court’s holding and reasoning and actually noted that the award would also be proper under Rule 11’s sanction power.¹⁶²

Moreover, as support for its limited bad faith exception timeline, the *Lamb* Court reasoned that a wrong on the court—litigation bad faith—is significantly worse than a wrong on an

¹⁵⁶ *Morganroth*, 213 F.3d at 1318 (internal quotation marks omitted).

¹⁵⁷ See *Flight Attendants*, AFL-CIO v. Horizon Air Indus., 976 F.2d 541, 550 (9th Cir. 1992).

¹⁵⁸ See *Hall v. Cole*, 412 U.S. 1, 5 (1973). Neither did *Chambers*, *Vaughan*, or any other leading Supreme Court opinions that ruled on the bad faith exception. See generally *Chambers v. NASCO, Inc.*, 501 U.S. 32 (1991); *Vaughan v. Atkinson*, 369 U.S. 527 (1962).

¹⁵⁹ See *infra* Part IV.B–C.

¹⁶⁰ See *Lamb Eng’g & Constr. Co. v. Neb. Pub. Power Dist.*, 103 F.3d 1422, 1437 (8th Cir. 1997).

¹⁶¹ See *Chambers*, 501 U.S. at 35.

¹⁶² See *id.* at 50. Rule 11 provides that by presenting a pleading to the court, an attorney represents—amongst other things—that the litigation “is not being presented for any improper purpose, such as to harass, cause unnecessary delay, or needlessly increase the cost of litigation.” FED. R. CIV. P. 11(b)(1).

individual—prelitigation bad faith.¹⁶³ That one conduct is worse, however, does not prevent both types of conduct from being sufficient to warrant the bad faith exception. *Chambers*, therefore, does not translate into excluding prelitigation conduct from the bad faith exception. In fact, the Court went out of its way to explain that its holding in no way ruled on whether the bad faith exception applies to prelitigation conduct.¹⁶⁴

Fifth, the Tenth Circuit, in *Morganroth*, limited the bad faith exception to litigation conduct because it considered such the holding of the majority of federal courts. This assertion is tenuous at best¹⁶⁵ and contradicts language of the Supreme Court at worst.¹⁶⁶ Moreover, merely counting the number of courts on each side of the split, without examining the underlying rationales and policies, is unwarranted.

Although courts have proposed different reasons for limiting the bad faith exception, none of these reasons—with the possible exception of policy—withstand scrutiny. Therefore, if it can be shown that expanding the bad faith exception to all prelitigation conduct is in line with the policies behind both the American rule and its bad faith exception, the remaining reasons offered by the courts for limiting the bad faith exception will be quashed.

B. *Circumventing the Policies Behind the American Rule*

The underlying policy behind the American rule is the desire not to deter parties from going to court. The rule does not want to deter parties that have a potential legal right.¹⁶⁷ Nevertheless,

¹⁶³ See *Chambers*, 501 U.S. at 44.

¹⁶⁴ *Id.* at 55 n.16 (“We . . . express no opinion as to whether the District Court would have had the inherent power to sanction *Chambers* for conduct relating to the underlying breach of contract . . .”). Incredibly, the *Lamb* Court interpreted *Chambers* as limiting the bad faith exception to litigation conduct when the *Chambers* Court explicitly avoided ruling on that issue. See *Lamb*, 103 F.3d at 1437.

¹⁶⁵ See *supra* Part III.B–D. Depending on how the D.C. Circuit and the Fourth Circuit cases are interpreted, there are between three and five circuits that extend the exception to prelitigation conduct, while there are three circuits that limit the exception to litigation. See *supra* Part III.B–D. Even if the *Morganroth* court did not include these other circuits in its analysis, there is still no clear majority that instructs the court to limit the exception.

¹⁶⁶ See *Hall v. Cole*, 412 U.S. 1, 15 (1973) (“It is clear, however, that ‘bad faith’ may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation.”).

¹⁶⁷ Such parties should not be required to pay both parties’ attorney fees should their claim not be successful, because the threat of such sanctions may prevent them

detering a bad faith party from bringing or defending court actions is not a goal of this policy.

Public policy, therefore, dictates that the exception should apply whether the bad faith was: (1) in the conduct underlying the claim; (2) in the obstinacy of a party refusing to recognize its opponent's clear legal right; or (3) in the litigation itself.¹⁶⁸

In support of the American rule, it has been argued that since litigation is at best uncertain one *should not be penalized for merely defending or prosecuting a lawsuit*, and that the poor might be unjustly discouraged from instituting actions to vindicate their rights if the penalty for losing included the fees of their opponents' counsel. Also, the time, expense, and difficulties of proof inherent in litigating the *question of what constitutes reasonable attorney's fees would pose substantial burdens for judicial administration*.¹⁶⁹

These policies—not deterring parties from “vindicat[ing] their rights”¹⁷⁰ and not burdening the judiciary to determine what “constitutes reasonable attorney's fees”¹⁷¹—should be used to determine whether the American rule or its bad faith exception applies.

The bad faith exception, therefore, should encompass all timelines¹⁷² because a bad faith party is not an intended beneficiary of the rule's protection.¹⁷³ The bad faith party is not “merely defending or prosecuting a lawsuit”;¹⁷⁴ rather the party is attempting to evade its obligation to compensate its opponent for its bad faith conduct. Applying the exception as such will not discourage the “poor” from vindicating their rights. Instead, they—and all parties—will only be discouraged from pursuing

“from instituting actions to vindicate their rights.” *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 717 (1967).

¹⁶⁸ For a clearer delineation of the possible timelines, see *supra* Part II.C.

¹⁶⁹ *Fleischmann*, 386 U.S. at 718 (emphasis added) (citations omitted).

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² This includes bad faith in the conducting underlying the claim.

¹⁷³ *But see* *Shimman v. Int'l Union of Operating Eng'rs, Local 18*, 744 F.2d 1226, 1232 (6th Cir. 1984) (“The rationale behind the American rule remains intact when there is bad faith in the event underlying the substantive claim. A person who harms another in bad faith is nonetheless entitled to defend a lawsuit in good faith.”).

¹⁷⁴ *Fleischmann*, 386 U.S. at 717.

litigation when they are undisputedly in the wrong and are nevertheless pursuing the claim for bad faith purposes.¹⁷⁵

Similarly, the concern of overburdening judicial administration does not favor limiting the bad faith exception to litigation conduct. This is especially true in circuits that have developed an efficient test to guide their courts in determining the reasonableness of attorney fee awards. For example, the Second Circuit has articulated a six-factor test for its courts to use when they order fee-shifting.¹⁷⁶ To ensure reasonableness, the Second Circuit has also required that the award be “cross-check[ed]” with the two available tests that evaluate the reasonableness of an attorney fee award.¹⁷⁷ Such a structured setting requires minimal judicial administration to ensure the reasonableness of an attorney award.

Moreover, a universal, all-encompassing bad faith exception will serve as deterrence against frivolous claims. Although empirical data is unavailable, logically, fewer claims will be filed and more claims will be settled if parties are on notice that their bad faith conduct will be punished.¹⁷⁸ Therefore, while extending the bad faith exception to prelitigation conduct will likely increase motions for attorney fees and the judicial resources

¹⁷⁵ An example of a bad faith purpose would be when the party intends to harass its opponent. Every true dispute, however, will not be subject to the bad faith exception or its fee-shifting penalty.

¹⁷⁶ In *Goldberger v. Integrated Resources, Inc.*, 209 F.3d 43, 50 (2d Cir. 2000), the Court of Appeals for the Second Circuit set forth six factors for its courts to consider when determining the amount of attorney fees to be awarded. These factors are: “(1) the time and labor expended by counsel; (2) the magnitude and complexities of the litigation; (3) the risk of the litigation . . . ; (4) the quality of representation; (5) the requested fee in relation to the settlement; and (6) public policy considerations.” *Id.* (quoting *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Regulation*, 724 F. Supp. 160, 163 (S.D.N.Y. 1989)).

¹⁷⁷ *See id.* In the Second Circuit, attorney fee awards are calculated by using either the “lodestar”—based on hours expended—or the “percentage of the fund”—contingency—method when determining the amount of the award. *Id.* Essentially, all courts utilize both methods, as whichever method a court does not use is still used to cross-check the award’s reasonableness. *See Wal-Mart Stores, Inc. v. Visa U.S.A., Inc.*, 396 F.3d 96, 123 (2d Cir. 2005) (“As a ‘cross-check’ to a percentage award, courts in this Circuit use the lodestar method.”) (quoting *Goldberger*, 209 F.3d at 50); *Goldberger*, 209 F.3d at 50 (“[T]he lodestar remains useful as a baseline even if the percentage method is eventually chosen.”).

¹⁷⁸ *See John F. Vargo, The American Rule on Attorney Fee Allocation: The Injured Person’s Access to Justice*, 42 AM. U. L. REV. 1567, 1612 (1993) (“In England, approximately ninety-nine percent of all claims for damages are settled before trial.”).

needed to determine the reasonableness of such fees, the courts' ability to avoid entire cases¹⁷⁹ will outweigh this additional use of resources. The judicial resources needed to rule on an attorney-fee motion involving a case with which the judge is familiar with are substantially less than the judicial resources needed to adjudicate a new case.¹⁸⁰

C. *Promoting the Policies Behind the Bad Faith Exception*

Interpreting the bad faith exception to apply to all three time periods also promotes the policies behind the exception. "Generally, the policies upheld through the award of costs and attorney's fees include: punishment of the losing party, indemnification of the prevailing party, and the deterrence of frivolous and bad faith litigation."¹⁸¹ A party acting in bad faith before the litigation should not be allowed to escape a fee-shifting punishment merely because his bad faith conduct occurred before the litigation; his conduct is just as culpable. Similarly, the party injured by the bad faith conduct deserves to be indemnified regardless of the timing of the bad faith. The injured party should not be responsible for legal costs that were only necessary due to his opponent's bad faith, regardless of when the bad faith occurred.¹⁸² Thus, any type of bad faith conduct, even prelitigation conduct, should be discouraged. It can be said, therefore, that applying the bad faith exception to all prelitigation bad faith conduct is directly in line with public policy. As stated by the Second Circuit: "Assessment of counsel fees under [bad faith] circumstances in no way conflicts with the primary justification for the rule against the shifting of counsel

¹⁷⁹ This will occur because bad faith parties will properly be deterred from bringing bad faith litigation.

¹⁸⁰ As a new case would involve new law, arguments, facts, procedures, and possibly jury selection, it is more efficient for a judge who is familiar with the case to rule on the motion. This author assumes that the *Fleischmann* Court's efficient judicial administration policy was only in the context of adding more motions without a simultaneous decrease in claim filings. See *Fleischmann Distilling Corp. v. Maier Brewing Co.*, 386 U.S. 714, 718 (1967). Otherwise, the argument presented here seems to refute the Court's policy. Such an assumption, however, is counterintuitive, as there will likely be an inverse relationship between the breadth of the bad faith exception and the number of claims filed.

¹⁸¹ Lord, *supra* note 7, at 86. For additional sources that explain the policies of the bad faith exception, see articles cited *supra* note 29.

¹⁸² See Gotanda, *supra* note 29; Greene, *supra* note 29; Cubita, *supra* note 1.

fees, namely, that the defendant should not be discouraged from fairly contesting the plaintiff's claims."¹⁸³

The Supreme Court intended for the bad faith exception to act as a punitive measure.¹⁸⁴ A uniform standard for the timeline of the exception will best effectuate the Court's objective.¹⁸⁵ Conversely, any inconsistency within the federal courts will weaken a law's intended deterrence, as a party will not be fully cognizant of the law and its effects or might think that it can evade the law's penalties.¹⁸⁶ This is especially true for intra-circuit splits, which create more upheaval regarding the state of the law.¹⁸⁷

D. *The Bottom Line*

The circuit courts' rulings reflect the confusion regarding the bad faith exception to the American rule for attorney fees.¹⁸⁸ Although such confusion is a natural progression of the discretionary nature of the exception, a district court's discretion should be limited to examining the specific facts of a case and determining whether the exception applies to such conduct.¹⁸⁹ The court, however, should not have discretion to choose which time period it examines when making its determination.¹⁹⁰

¹⁸³ *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1309 (2d Cir. 1973). This Second Circuit case was decided immediately before the Supreme Court's *Hall v. Cole* decision. *See id.* at 1281 (decided May 9, 1973); *Hall v. Cole*, 412 U.S. 1, 1 (1973) (decided May 21, 1973).

¹⁸⁴ *See Chambers v. NASCO, Inc.*, 501 U.S. 32, 53 (1991); *Hall*, 412 U.S. at 5.

¹⁸⁵ *See Chipser*, *supra* note 1, at 331.

The exception is used only as a remedy for abuse and unnecessary . . . delay caused by bad faith and obstinacy. Instances of abuse of the exception will be rare, and *its misapplication can be reduced to a minimum if judges and litigants make sure the developed standards are carefully applied.*

Id. (emphasis added).

¹⁸⁶ A party might assume that its case will be decided in accordance with those courts that interpret the bad faith exception in a narrow sense.

¹⁸⁷ *See, e.g., supra* notes 113–20, 140–42 and accompanying text (discussing the Second Circuit's split regarding the bad faith exception's timeline).

¹⁸⁸ There is a fractionalized debate as to when the bad faith conduct must occur to warrant the exception.

¹⁸⁹ In other words, the court must use its discretion to determine whether the facts of the case before it are sufficient to warrant the bad faith exception and its fee-shifting consequence.

¹⁹⁰ *See Hall v. Cole*, 412 U.S. 1, 9 n.13 (1973) ("Although this consideration is undoubtedly an important one, it is relevant, not to the power of federal courts to

V. PROPOSAL

A. *Uniform Timeline*

All federal courts should broaden the bad faith exception to include all time periods—beginning with the conduct that is underlying the claim and ending with the conclusion of the litigation. This is consistent with the simple reading in *Hall v. Cole*, where the Court—without any request to rule on the matter—stated: “It is clear, however, that ‘bad faith’ may be found, not only in the actions that led to the lawsuit, but also in the conduct of the litigation.”¹⁹¹ Even the courts that interpret *Hall* narrowly¹⁹² still agree that *Hall* recommends the bad faith exception be applied to the middle timeline.¹⁹³

If *Hall* is read narrowly and only extends the bad faith exception to the middle timeline,¹⁹⁴ the exception’s policies would be promoted *nearly* as efficiently as if this Note’s proposal—that *all* prelitigation conduct should be subject to the exception—were followed. Typically, when conduct underlying the claim is made in bad faith, the injured party is before the court because its opponent is obstinately refusing to recognize its clear legal right. For example, in this Note’s theoretical case involving the intentional arson and subsequent fraudulent insurance claim,¹⁹⁵ it is clear to the business owner, once he is convicted of insurance fraud, that the insurance company has a legal right to its payout.¹⁹⁶ Therefore, even under the narrower interpretation of

award counsel fees generally, but, rather, to the *exercise of the District Court’s discretion on a case-by-case basis.*” (emphasis added)).

¹⁹¹ *Id.* at 15.

¹⁹² *See supra* Part III.C.

¹⁹³ *See supra* Part III.C. This is when the losing party’s refusal to recognize the prevailing party’s clear legal right forced the prevailing party to go to court to enforce its right. Although this interpretation of *Hall* can be squared with the Court’s language, it overlooks the policies behind the American rule and the bad faith exception. *See supra* Part IV.B–C.

¹⁹⁴ *See supra* Part III.C. “Only” distinguishes between the two distinct prelitigation categories, but the exception certainly also applies to litigation bad faith conduct.

¹⁹⁵ *See supra* text accompanying note 6.

¹⁹⁶ In other words, a party guilty of prelitigation bad faith conduct generally also forces its adversary to go to court to enforce its clear legal right. An important exception to this general rule occurs when the conduct underlying the claim was in bad faith, yet a true legal dispute remains—whether the bad faith party owes its opponent damages on account of its bad faith conduct. For example, consider a

Hall,¹⁹⁷ prelitigation bad faith conduct typically leads to the same result: fee-shifting for the injured party.

This Note does not advocate that a court's decision to apply the exception should no longer be discretionary; rather it touts the benefits to the legal system should the scope of the court's discretion include all bad faith conduct. Not all prelitigation bad faith conduct or, for that matter, litigation bad faith conduct¹⁹⁸ will necessarily be subject to the bad faith exception. For example, if a jury finds that the defendant intentionally defrauded the plaintiff, the bad faith exception automatically warranted?¹⁹⁹ What if the defendant still maintains his innocence and the plaintiff's star witness lied because of a vendetta? Such situations are addressed by the judge, the arbiter of the exception's applicability, and not the jury. Not only does the judge decide whether to apply the exception, but the exception's very nature is discretionary.²⁰⁰ The exception is only to be applied when the conduct is of extreme bad faith and the fee-shifting serves the interests of justice.²⁰¹ Therefore, should

partner in a law firm who cheated his partners out of \$2 million during the "winding up"—the period after the dissolution but before all the accounts are settled—of the partnership. The bad faith partner then declared bankruptcy. The remaining legal question is whether the bad faith partner had a fiduciary duty to his fellow partners during the winding up of the partnership. The claims against the partner cannot be discharged in bankruptcy if he had a fiduciary duty at the point he committed the fraud. This is similar to the facts of *Shibolet v. Yerushalmi (In re Yerushalmi)*, 393 B.R. 288, 292, 295 (Bankr. E.D.N.Y. 2008).

Assuming the claims against the partner are found to be nondischargeable, the judge must make a fine distinction in applying the bad faith exception. If the judge determines that bad faith conduct underlying the action warrants the bad faith exception, he can award attorney fees for the injured partners. If, however, the judge determines that the exception is only warranted for the middle timeline, attorney fees should not be awarded here as the bad faith partner did not deny his opponents their clear legal right; the *legal* rights of his partners were unclear and litigation was necessary to clarify them.

¹⁹⁷ See *supra* text accompanying notes 107–11.

¹⁹⁸ As this Note proposes that all prelitigation conduct be subject to the bad faith exception, the analysis focuses on all three time periods.

¹⁹⁹ See *Morganroth & Morganroth v. DeLorean*, 213 F.3d 1301, 1318 (10th Cir. 2000) (“[A] defendant found liable for fraud, for instance, would automatically be guilty of bad faith with respect to the underlying cause of action, thus abrogating the American rule in all successful fraud actions.”); *supra* text accompanying notes 138, 150–56.

²⁰⁰ *Hall v. Cole*, 412 U.S. 1, 9 n.13 (1973).

²⁰¹ See *Beaudry Motor Co. v. ABKO Props., Inc.*, 780 F.2d 751, 756 (9th Cir. 1986). An example of when an attorney award for extreme bad faith conduct would not serve the interests of justice is when the prevailing party has also been guilty of

the judge determine that the defendant's guilt is questionable, the judge can refuse to apply the bad faith exception.

B. Procedural Effects of the Proposal

The proposal has important procedural implication. Despite jury charges to the contrary, juries often factor an attorney fee into the award amount.²⁰² Therefore, juries should be informed before they reach a verdict of the possibility that the prevailing party's attorney fees may be paid by the party's opponent.²⁰³

C. Predictability as Deterrence

If this proposal were to be adopted by all the circuits, litigants would be more certain as to the exception's timeline, which would induce: (1) less litigation regarding the applicability of the bad faith exception; (2) less obstinacy by bad faith parties; and (3) perhaps even less bad faith conduct due to the possible punitive punishment. Certainty, consistency, and clarity are important priorities of the judicial system. Moreover, once a party is clearly put on notice as to which bad faith conduct will be punished with fee-shifting, the exception will serve as a more efficient disincentive. Such notice will deter illegitimate behavior inside and outside of the courtroom, an important purpose of the

misconduct. See, e.g., *In re Kaid*, 347 F. Supp. 540, 543–44 (E.D. Va. 1972); *Lee Nat'l Corp. v. Kan. City S. Indus.*, 50 F.R.D. 412, 415 (S.D.N.Y. 1970).

²⁰² See Leubsdorf, *supra* note 1, at 14 & n.31 (“[I]t is quite likely that juries [take] legal expenses into consideration when they asses[] damages . . .”).

²⁰³ This is still troubling as the jury will not know the judge's ruling on the motion for attorney fees when it decides its verdict. Therefore, it is a financial risk for a party to make a motion for attorney fees: Even if an attorney calculates that there is a 50% chance the judge will grant the motion—and therefore the award—if the attorney also calculates a 60% chance that the jury will minimize its award due to his motion, the motion has a negative expectation value (50% X < 60% X). This is even worse than a pure chance game. The jury will assume that the attorney will receive the typical one-third contingency fee and will increase its award accordingly; a reasonable attorney fee award, however, is often less than that. See, e.g., *Goldberger v. Integrated Res., Inc.*, 209 F.3d 43, 51 (2d Cir. 2000) (finding 25% to be a typical attorney fee award). Therefore, even if the judge orders fee-shifting, requesting such fees may be a net loss for the moving party. This scenario is more a fundamental problem with juries improperly factoring the attorney fees into their awards than it is a defect in the bad faith exception.

exception.²⁰⁴ Finally, this clear notice will also help prevent “harm done to the court itself,”²⁰⁵ an underlying tenet of the bad faith exception.

CONCLUSION

The current bad faith exception is applied chaotically by federal courts. While all courts agree that bad faith conduct during the litigation is subject to the exception, they are divided over whether the prelitigation time periods are also within the exception's scope. Some circuits have ignored the Supreme Court's language altogether. Others have overlooked the policies behind both the American rule and its bad faith exception.²⁰⁶ To remedy the chaos, the exception should be applied to all bad faith conduct—including both prelitigation time periods. Applying the exception in this manner does not contradict the policies of the American rule because the party acting in bad faith is not being punished for bringing an action; it is being punished for bringing the action *in bad faith*. Moreover, applying the exception to all bad faith conduct will deter such conduct, serve the interests of justice by indemnifying the prevailing party, and punish the bad faith actor.

²⁰⁴ See Leubsdorf, *supra* note 1, at 29 (“The ‘bad faith’ doctrine . . . awards attorney fees against parties who litigate in bad faith, for the obvious purpose of deterring illegitimate behavior in the courtroom, and sometimes outside it.”).

²⁰⁵ *Chambers v. NASCO, Inc.*, 501 U.S. 32, 55 n.17 (1991) (explaining that the shareholder's “fraudulent transfer of assets [that] took place before the suit was filed,” but after he was “given notice . . . of the pending suit” perpetrated a “harm done to the court itself”). Such harm likely refers to the wasted judicial resources required to adjudicate bad faith actions. See *id.*; *Hazel-Atlas Glass Co. v. Hartford-Empire Co.*, 322 U.S. 238, 246 (1944) (“[T]ampering with the administration of justice . . . is a wrong against the institutions set up to protect and safeguard the public . . .”); *supra* text accompanying notes 177–80.

²⁰⁶ Adding to the chaos, the Second Circuit has an internal split regarding the exception's timeline. See *supra* note 142.