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Ignorance (of the Law) Is Bliss

Examining Subjective, Unreasonable Good Faith and the Discharge Injunction

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The U.S. Supreme Court has long recognized that one of the fundamental purposes of bankruptcy is to release honest debtors from oppressive debts.[1] Section 524 of the Bankruptcy Code provides for a discharge, designed to "ensure that debtors receive a 'fresh start' and are not unfairly coerced into repaying discharged prepetition debts,"[2] and to "eliminate any doubt concerning the effect of the discharge as a total prohibition on debt-collection efforts."[3]

Bankruptcy courts are empowered to safeguard this fresh start and deter creditor misconduct by invoking their civil contempt powers under § 105. Under § 105, bankruptcy courts may "issue any order, process, or judgment that is necessary or appropriate to carry out"[4] Code provisions. However, contempt may often be the only remedy for a discharge injunction.

In *In re Taggart*, the Ninth Circuit Court of Appeals held that a creditor's knowing violation of the discharge injunction does not warrant civil contempt when the creditor had a subjective, good-faith belief that the discharge did not pertain to its claim, even if that belief is "unreasonable."[5] However, this ruling conflicts with the First,[6] Fourth[7] and Eleventh Circuits,[8] as well as two bankruptcy appellate decisions,[9] not to mention dozens of lower court decisions. The Supreme Court granted *certiorari* to resolve the circuit split relating to this bedrock principle of bankruptcy law: the discharge injunction. It will decide whether, under the Bankruptcy Code, a creditor's good-faith belief that the discharge injunction does not apply precludes a finding of civil contempt.

In determining whether a violation of the discharge injunction occurred, *Taggart* considered a two-part test: whether the violating creditor (1) knew the discharge injunction was applicable, and (2) intended the actions that violated the injunction.[10] An interpretation of the first prong of this test was at the heart of the issue in *Taggart*.

The Majority View and the Discharge Landscape

Before *Taggart*, the majority of courts considering whether a creditor violated the discharge injunction held that the creditor's subjective good-faith intent was irrelevant. For example, more than two decades ago, the Eleventh Circuit in *In re Hardy* held that § 105 grants courts independent statutory contempt powers to award monetary and other sanctions regardless of the creditor's subjective good faith.[11] The *Hardy* court reasoned that "the focus of the court's inquiry in civil contempt proceedings is not on the subjective beliefs or intent of the alleged contemnors in complying with the order, but whether in fact their conduct complied with the order at issue."[12] Under § 105, a showing of "bad faith" is not required.[13]

Likewise, the First Circuit in *In re Pratt* acknowledged that the "federal bankruptcy law interest in according debtors a fresh start, free from objectively coercive reaffirmation demands, must be accorded supremacy."[14] In *Pratt*, the debtors moved to reopen their bankruptcy case to seek sanctions against a creditor whose claim was secured by an interest in the debtors' motor vehicle. The debtors alleged that the creditor violated the discharge injunction by refusing to either release its secured lien or repossess the vehicle.[15]

On appeal, the First Circuit relied on its earlier decision in *Fleet Mortgage Group Inc. v. Kaneb*.[16] In *Kaneb*, the court rejected the argument that a violation of the automatic stay was not willful if the creditor had made a good-faith mistake. Instead, the court held that the standard for a willful violation is met "if there is knowledge" of the automatic stay and "the defendant intended the actions which constituted the violation."[17] Applying *Kaneb*'s reasoning to violations of the discharge injunction, the First Circuit in *Pratt* held that although the creditor's actions were

1 *Local Loan Co. v. Hunt*, 292 U.S. 234, 244, 54 S. Ct. 695, 699, 78 L. Ed. 1230 (1934) (finding that purpose of Bankruptcy Act was to "relieve the honest debtor from the weight of oppressive indebtedness") (quoting *Williams v. U.S. Fid. & Guar. Co.*, 236 U.S. 549, 554, 35 S. Ct. 289, 290, 59 L. Ed. 713 (1915)).
2 *In re Pratt*, 462 F.3d 14, 19 (1st Cir. 2006).
3 *In re McLean*, 794 F.3d 1313, 1321 (11th Cir. 2015) (citing H.R. Rep. No. 95-595, at 365-66 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6321)).
4 *Id.* at 1319; *see also* 11 U.S.C. § 105(a).
5 *Lorenzen v. Taggart (In re Taggart)*, 888 F.3d 438, 444 (9th Cir. 2018).
6 *In re Pratt*, 462 F.3d at 21.
7 *In re Fina*, 550 Fed. App'x 150, 155 (4th Cir. 2014).
8 *In re Hardy*, 97 F.3d 1384, 1390 (11th Cir. 1996).
9 *In re Martin*, 474 B.R. 789 (B.A.P. 6th Cir. 2012) (unpublished); *In re Culley*, 347 B.R. 115 (B.A.P. 10th Cir. 2006) (unpublished).
10 *In re Taggart*, 888 F.3d at 443 (citing *In re Bennett*, 298 F.3d 1059, 1069 (9th Cir. 2002)).
11 *In re Hardy*, 97 F.3d at 1389-90.
12 *Id.* (citing *Howard Johnson Co. v. Khimani*, 892 F.2d 1512, 1516 (11th Cir. 1990)).
13 *Id.* at 1390.
14 *In re Pratt*, 462 F.3d 14, 20 (1st Cir. 2006).
15 *Id.* at 16.
16 196 F.3d 265 (1st Cir. 1999).
17 *Id.* at 21.

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not in "bad faith," they were objectively coercive in their effect and thus willfully violated the discharge injunction.[18]

After *Taggart* was decided, the First Circuit in *Internal Revenue Serv. v. Murphy* reaffirmed *Pratt* and held that the term "willful" has an established meaning, under which a creditor's "good-faith belief in a right to the property is not relevant to a determination of whether the violation was willful."[19] The First Circuit reasoned that under the creditor's interpretation, "it is hard to imagine a case where a [debtor] could ever collect against [a creditor] for a violation of the automatic stay or discharge order," which would render a debtor's legal protections a "near nullity" because a creditor "encounters no risk" for pursuing discharged debts "as long as it has a 'good faith' or 'reasonable belief' for its conclusions."[20]

Similarly, the Fourth Circuit in *In re Fina* held that the creditors' intentions were "irrelevant" in determining whether it had violated the discharge injunction because "a good-faith mistake is generally not a valid defense."[21] Since there was no dispute that the creditors were aware of the discharge injunction when they filed an action against the debtor, the creditors' violation was deemed willful.[22] In reaching that conclusion, the *Fina* court noted that the creditors had bypassed the bankruptcy court's discharge injunction and that "[t]he proper course for the appellants was to first seek leave of the bankruptcy court before pursuing a judgment against the debtor."[23]

Each of these courts rejected the application of a subjective approach in determining whether a violation of the discharge injunction was willful. Then the Ninth Circuit decided *In re Taggart*, thus creating a circuit split on the issue.

In re Taggart: Facts and Analysis

Before filing for bankruptcy, the chapter 7 debtor in *Taggart* allegedly transferred his interest in a limited liability company (LLC) without providing notice and an opportunity for the other members to exercise their right of first refusal. The other members sued the debtor for breach of the LLC's operating agreement.[24] On the eve of trial, the debtor filed a chapter 7 case.[25]

After the debtor received his discharge, the state court action continued; the state court judge found the debtor to be a "necessary party," although no monetary judgment could be awarded against him.[26] The other LLC members prevailed on their breach-of-contract claim and sought attorneys' fees against the debtor, limiting their request to fees incurred *after* the date of the debtor's bankruptcy.[27] While the attorneys' fee motion was pending in state court, the debtor moved to reopen his bankruptcy case, then moved for an order holding the LLC members (and their attorney) in contempt for violating the discharge injunction.[28] Before the bankruptcy court, the state court held that the debtor was liable for the attorneys' fees because he "returned to the fray" of litigation after his bankruptcy discharge.[29] The debtor appealed.[30]

> **Those in the *Taggart* camp argue that the standard adopted by the Eleventh Circuit in *Hardy* imposes a "near-strict-liability standard for contempt[.]"**

Several state and bankruptcy court appeals ensued, but it is the ruling of the bankruptcy appellate panel, which reversed the bankruptcy court's finding of contempt, that led to the Ninth Circuit decision. The Ninth Circuit affirmed and held that the creditors were "insulated" from a finding of contempt because they had a good-faith belief, even if unreasonable, that the discharge injunction did not apply to their claim for post-petition attorneys' fees.[31] In so finding, the Ninth Circuit reasoned that the bankruptcy court applied the incorrect standard when it found that it was "irrelevant whether the creditors held a subjective good-faith belief that the discharge injunction did not apply to their claim."[32]

Instead, the Ninth Circuit held that the "applicability of the injunction must be proved as a matter of fact and may not be inferred simply because the creditor knew of the bankruptcy proceeding."[33] Relying on an earlier Ninth Circuit decision in *In re Zilog Inc.*,[34] the *Taggart* court held that "the creditor's good-faith belief that the discharge injunction does not apply to the creditor's claim precludes a finding of contempt, even if the creditor's belief is *unreasonable*."[35]

Although the Ninth Circuit acknowledged some tension between its holding and its earlier opinions, the court concluded that the creditor must know that the discharge injunction is "applicable" to the creditor's claims to be liable.[36] In the end, the Ninth Circuit reversed the sanctions award because the creditors held a mistaken good-faith belief that the discharge injunction did not apply to their claims.

Ramifications of a Supreme Court Decision

The Supreme Court is now tasked with resolving this circuit split by determining whether a creditor's good-faith belief that the discharge injunction does not apply precludes

18 *Id.* at 20.
19 *Internal Revenue Serv. v. Murphy*, 892 F.3d 29, 34 (1st Cir. 2018) (quoting *Fleet Mortg. Grp. Inc. v. Kaneb*, 196 F.3d 265, 269 (1st Cir. 1999)).
20 *Id.* at 42.
21 550 Fed. App'x 150, 155 (4th Cir. 2014) (citing *In re Strumpf*, 37 F.3d 155, 159 (4th Cir. 1994) (evaluating willfulness in context of automatic stay violation and stating that "[t]o constitute a willful act, the creditor need not act with specific intent but must only commit an intentional act with knowledge of the automatic stay.")).
22 *Id.* at 155.
23 *Id.* at 156.
24 *In re Taggart*, 888 F.3d 438, 439 (9th Cir. 2018).
25 *Id.* at 441.
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.* at 442.
30 *Id.*
31 *Id.* at 444.
32 *Id.* at 443.
33 *Id.*
34 450 F.3d 996, 1007 (9th Cir. 2006).
35 *In re Taggart*, 888 F.3d at 444 (emphasis added).
36 *Id.*

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a finding of civil contempt. In essence, can ignorance of the law be a valid defense to a discharge-injunction violation?

Arguments Against Affirmance

Taggart could have widespread unintended implications if it is affirmed. First, it could erode the power of the discharge injunction, a fundamental purpose of bankruptcy. As noted in one *amicus* brief, the Ninth Circuit's decision is inconsistent with the Supreme Court's acknowledgment that the discharge injunction protects the "fresh start."[37] The bankruptcy discharge has the ability to restore financially stable, yet fragile, debtors who emerge from bankruptcy, protecting them from creditors who engage in abusive conduct and coerce debtors to pay discharged debts.

Taggart creates a "broad exception to the discharge injunction that renders it virtually meaningless"[38] and impairs this core protection afforded to debtors with only a "toothless" injunction left in § 524 to protect them.[39] Without a powerful sanction to serve as a deterrent, this could foster gamesmanship, which would result in harm to the system's integrity by removing risk to creditors for a violation. There is a potential for widespread abuse by overzealous creditors that can feign a good-faith belief, even when all of the objective facts point to an opposite result.

Second, under *Taggart*'s reasoning, a court must evaluate the subjective belief of a creditor that, knowing of the court's discharge order, proceeded to collect on a discharged debt under a mistaken belief that the discharge injunction was not "applicable" to that debt. The debtor's burden of proof to prevail on a willful violation is already high under the majority rule. An affirmance of *Taggart* could result in an unintentional shift of the burden to the debtor to prove the creditor's lack of good faith, not to mention the expense of attempting to do so. As the *Fina* court recognized, this cost and expense can be easily avoided by the creditor returning to the bankruptcy court for an order on the applicability of the discharge injunction.

Third, the *Taggart* decision is contrary to the spirit of longstanding precedent. The body of jurisprudence that has developed with respect to the discharge injunction rejects the notion that ignorance of the law should shield a creditor from contempt sanctions.

Arguments for Affirmance

On the other hand, as noted by the U.S.'s *amicus* brief,[40] it is not always clear — particularly in a chapter 7 case — what debts are subject to the discharge injunction because the discharge order provides only that a "discharge under 11 U.S.C. § 727 is granted."[41] A creditor might be aware of a bankruptcy discharge, but is not on specific notice that its particular debt was discharged.

Since the Bankruptcy Code provides that a discharge order "operates as an injunction,"[42] it should be governed by the principles of civil contempt. However, civil-contempt sanctions cannot be imposed if there is a fair ground of doubt that the conduct violated the injunction.[43] Principles of "basic fairness require ... that those enjoined receive explicit notice of precisely what conduct is outlawed." These principles should be extended to the bankruptcy-discharge analysis.[44]

Conclusion

Those in the *Taggart* camp argue that the standard adopted by the Eleventh Circuit in *Hardy* imposes a "near-strict-liability standard for contempt" where a creditor is subject to contempt sanctions by virtue of its knowledge of the discharge and intentionally committing an act that violates it.[45] Adopting this standard is impractical because it authorizes civil contempt remedies in circumstances where the creditor was not aware, or had reasonable doubt, as to the applicability of the discharge injunction to a particular debt.

Is ignorance truly bliss? We will know soon, with oral argument set April 24, 2019. What is your vote? abi

37 Brief of Hon. Eugene Wedoff, *et al*., as *Amici Curiae*, p. 24, *Taggart v. Lorenzen*, 18-489.
38 Brief of the National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys as *Amicus Curiae*, p. 4, *Taggart v. Lorenzen*, 18-489.
39 Brief of Hon. Eugene Wedoff, *et al*., as *Amici Curiae*, p. 6, *Taggart v. Lorenzen*, 18-489.
40 Brief of United States as *Amicus Curiae*, p. 3, *Taggart v. Lorenzen*, 18-489.
41 Official Bankruptcy Form No. 318, at 1.
42 11 U.S.C. § 524(a)(2).
43 Brief of United States as *Amicus Curiae*, p. 10, *Taggart v. Lorenzen*, 18-489.
44 *Id.* at 10 (quoting *Schmidt v. Lessard*, 414 U.S. 473, 476 (1974) (*per curiam*)).
45 *Id.* at 11.