Benchnotes

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"Good Faith" Belief that Taxes Were Exempt Did Not Excuse IRS from Liability for "Willful Violations"

In *Internal Revenue Service v. Murphy*,[1] the First Circuit considered the meaning of the phrase "willfully violates" as it appears in 26 U.S.C. § 7433(e). This provision of the Internal Revenue Code authorizes private taxpayers to sue the U.S. where the Internal Revenue Service (IRS) or its agents "willfully violate" the automatic stay or a discharge injunction.

In the underlying dispute, the taxpayer had obtained a discharge in 2006, but the IRS persisted in collection efforts for taxes that an assistant U.S. attorney believed to be exempt from discharge under § 523(a)(1)(C). The assistant U.S. attorney responsible for the file believed that the debtor had evaded taxes and was not entitled to a discharge. However, the IRS never objected to the discharge, despite having notice of the debtor's bankruptcy and ample opportunity to do so.

In 2009, with notice of the debtor's discharge, the IRS issued levy notices on the debtor's companies, seeking to collect the predischarge tax obligations. Months after the IRS issued the levy notices, the debtor filed an adversary proceeding to determine whether his taxes had been discharged. The bankruptcy court granted summary judgment in the debtor's favor, concluding that the IRS failed to present sufficient evidence to show a genuine issue of fact. With that decision in hand, the debtor filed a second adversary proceeding for damages under 26 U.S.C. § 7433(e), based on the IRS's willful violations of the discharge injunction. The bankruptcy court granted summary judgment in the debtor's favor, concluding that the factual issues had already been decided.

The district court vacated on appeal and remanded for the bankruptcy court to consider whether the assistant U.S. attorney's diagnosis of "frontotemporal dementia" impacted its decision regarding whether the IRS "willfully violated" the discharge injunction. As part of a settlement, the IRS agreed to pay the debtor $175,000 if the court of appeals agreed with the bankruptcy court on appeal. Ultimately, the court of appeals sided with the bankruptcy court.

While the phrase "willfully violates" was not defined within 26 U.S.C. § 7433(e), the court of appeals explained that the phrase "is a chameleon"[2] with "many meanings whose construction is often dependent on the context in which it appears."[3] Thus, the court considered bankruptcy authorities addressing "willful violations" of the automatic stay and discharge injunctions prior to 1998, when Congress enacted 26 U.S.C. § 7433(e). Considering such pre-1998 authorities, the court concluded that a creditor willfully violates the automatic stay or discharge injunction, as applicable, if it knows of the stay or injunction and takes an intentional action that violates the automatic stay or injunction: "A good-faith belief in a right to the property was not relevant to determining whether the creditor's violation was willful." This conclusion was supported by post-1998 decisions in *Fleet Mortgage and Pratt*.[4]

The court rejected the IRS's argument that § 7433(e) should be construed narrowly simply because it is a waiver of sovereign immunity. While the government was not required to seek predetermination regarding that status of a tax obligation before pursuing collection efforts, the court explained that there were several alternatives available to the IRS before taking the steps that resulted in "willful violations" of the discharge.

The court further explained that there were compelling policy justifications within the statute itself to hold the IRS accountable for its actions. Since the assistant U.S. attorney knew about the discharge injunctions and took affirmative steps to collect on the discharged taxes, the court of appeals agreed that the IRS "willfully violated" the discharge injunction, notwithstanding the assistant U.S. attorney's apparent cognitive impairment and good-faith beliefs. Thus, the bankruptcy court's summary judgment was affirmed.

No "Actual Conflict" Existed to Bar Retention, Despite Law Firm's Prior Representation of a Creditor

In *Relativity Media*,[5] the debtor sought to retain Winston & Strawn as its counsel under § 327(a). Prior to the bankruptcy filing, the law firm had represented Netflix in connection with unrelated patent litigation with a third party. In the bankruptcy case, Netflix was a significant creditor and party-in-interest because of a key contract between the debtor and Netflix over distribution rights. Two objections were filed in response to the debtor's application to employ Winston & Strawn: one by Netflix and one by the U.S. Trustee.

The court first noted that Winston & Strawn qualified under § 327(a), and, but for the "faint

1 892 F.3d 29, 2018 U.S. App. LEXIS 15390 (1st Cir. 2018).
2 *Id.* at *10 (quoting *United States v. Marshall*, 753 F.3d 341, 345 (1st Cir. 2014)).
3 *Id.* (quoting *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 59, 127 S. Ct. 2201, 167 L. Ed. 2d 1045 (2007)).
4 *See, e.g., Fleet Mortg. Grp. v. Kaneb*, 196 F.3d 265, 268 (1st Cir. 1999); *Pratt v. GMAC (In re Pratt)*, 462 F.3d 14, 21 (1st Cir. 2006).
5 *In re Relativity Media LLC*, 2018 Bankr. LEXIS 2037 (Bankr. S.D.N.Y. July 6, 2018).

color" of conflicts arising from the firm's prior representation of Netflix, the firm itself was a "disinterested person" and did not hold or represent interests adverse to the estate. Next, the court considered § 327(c), which prohibits the employment of a law firm that also represents or has represented a creditor if there exists an "actual conflict of interest." The court noted that § 327(c) is different from the "disinterestedness" standards under § 327(a), notably because the bar is mandatory when raised by a creditor and an actual conflict is proven.

In the present case, however, the court explained that no such actual conflict of interest existed. While the Netflix contract was valuable to the estate, the court also noted that there were other assets to be sold, "financing to be finalized, a sale process to complete, a claims process to administer, and all the other things that Chapter 11 requires." Thus, the court concluded that the unrelated patent litigation, "whether that representation is continuing or not," is not a proper ground for a general disqualification of Winston & Strawn under § 327(c).

Nevertheless, the court recognized that Netflix had rights, too. Specifically, the court recognized that even if Winston & Strawn's withdrawal from representing Netflix in the patent litigation alleviated concerns over its disinterestedness for purposes of § 327(a), the withdrawals did not mean that the firm could represent the debtor in potential disputes with Netflix. Moreover, the court held that the "waivers" included in Winston & Strawn's retention letter with Netflix and subsequent emails were ineffective to waive the potential conflict arising from the law firm's proposed representation of the debtor. Further, the court explained that none of the letters or emails specifically referenced the dispute between the debtor and Netflix as a matter being waived, thus Netflix could not be deemed to have provided its "informed consent" to waive something that did not exist at the time and was never specifically referenced in writing.

Recognizing the tension between the debtor's need to retain counsel and Netflix's right to prevent Winston & Strawn from representing the debtor in litigation against it, the court concluded that the employment application could be granted. However, it was only conditioned upon the debtor's retention of separate special counsel to handle any disputes with Netflix. With that condition, the application was approved.

Miscellaneous

• *In re World Marketing Chicago LLC*, 584 B.R. 737 (Bankr. N.D. Ill. 2018) (bankruptcy court held that *Barton* doctrine (requiring advance court permission before suing bankruptcy trustee) does not apply to suit against bankruptcy trustee filed in same bankruptcy court that appointed trustee; court stated that "[n]othing in *Barton* ... stands for the proposition that a party cannot sue a trustee in the bankruptcy court itself. Why would it? There is no usurpation of the bankruptcy court's power if the suit is brought in the bankruptcy court itself. The integrity of the bankruptcy court's jurisdiction is preserved").

• *In re DVR LLC*, 582 B.R. 507 (Bankr. D. Colo. 2018) (court held that mandatory language of § 502(b), which provides that upon objection to proof of claim court "shall determine" amount of claim, did not prevent court from approving settlement by bankruptcy trustee of that same claim with claimant, thereby mooting objecting creditor's pending claim objection; court found that when claim objection involves individual claims of objector against creditor who filed claim to which objection is raised (such as dispute over competing lien rights), then trustee does not have authority to settle objection, regardless of powers conferred to it by Bankruptcy Rule 9019; however, because objecting creditor in this case was not asserting any rights personal to it, trustee could step in and resolve claim objection by settlement);

• *In re Fishel*, 583 B.R. 474 (Bankr. W.D. Wis. 2018) (chapter 13 trustee moved to dismiss consumer debtor's bankruptcy case because she had more than statutory limit of unsecured debt under § 109(e) (*i.e.*, $394,725) when her nondischargeable student loan debts were included in analysis; bankruptcy court denied motion; noting split in case law regarding whether § 109(e) is jurisdictional or merely sets forth debtor's eligibility, court held that eligibility is not jurisdictional; in deciding whether case should be dismissed under § 1307 for cause, court found that even where cause exists, courts "may still decline to convert or dismiss" case; in so doing, court noted that (1) debtor could make proposed plan payments, (2) no other parties had objected and (3) student loan debt was nondischargeable in any event);

• *In re Health Diagnostic Laboratory Inc.*, 584 B.R. 525 (Bankr. E.D. Va. 2018) (liquidating trust oversight committee appointed pursuant to debtors' chapter 11 plan filed motion asking that interim liquidating trustee be appointed as permanent liquidating trustee; two of debtors' board members, who were defendants in breach-of-fiduciary-duty claims being pursued by interim trustee, objected to motion on basis that trustee had served as debtors' pre-petition financial advisor and chief restructuring officer, and had participated in meetings of debtor's board; noting that "few cases have touched directly upon the legal standard applicable to the appointment of a trustee for a post-confirmation liquidating trust," court held that liquidating trustee need not be "disinterested person" and that, in present case, interim trustee did not suffer from any debilitating conflicts of interest that would preclude him from being appointed on permanent basis); and

• *In re Indiana Hotel Equities LLC*, 2018 WL 3025293 (Bankr. E.D. Mich. June 18, 2018) (debtor commenced chapter 11 case after state court ruled that debtor had defaulted on a nonresidential real property lease, landlord validly terminated lease and debtor had no right to possession; noting split in authority, bankruptcy court held that § 362(d)(10), which provides that automatic stay does not apply to any act by landlord to obtain possession of nonresidential real property it leased to debtor when lease "has terminated by the expiration of the stated term of the lease," does not apply where lease was terminated early by landlord due to default by debtor/lessee; court suggested that result might have been different if landlord had also sought stay relief for "cause" under § 362(d)(1)). abi