

Contempt Standard For Chasing Invalid Debts Hangs On Intent

By James T. Bentley, Schulte Roth & Zabel LLP (May 3, 2019, 6:33 PM EDT)

Generally, a bankruptcy case concludes with a discharge order, which operates as an injunction against the commencement or continuation of an action by a creditor to recover on most prepetition debts under Section 524 of the Bankruptcy Code.[1]

On April 24, 2019, the U.S. Supreme Court heard oral argument in *Taggart v. Lorenzen* on whether a creditor's good faith belief that a debtor's discharge injunction does not apply to the creditor's claim precludes a finding of civil contempt.

In its briefing, the debtor in this case argued that a creditor who violated a discharge injunction was, *per se*, liable for contempt and sanctions. The creditors argued that the court should consider whether an honest mistake had been made.

The implications of this decision could have a far-reaching impact on how or whether creditors decide to pursue certain claims against debtors.

Facts

This case arises from a dispute among members of a limited liability company. The operating agreement provided a right of first refusal to each member should another member decide to sell his or her interest. Bradley Taggart, one of the LLC's members, sold his membership interests to his attorney, resulting in the other members, the creditors, suing him and his attorney in state court for breach of contract and to unwind the sale. On the eve of trial, Taggart filed for bankruptcy, and the state court action was stayed. Ultimately, Taggart received a bankruptcy discharge.

Subsequently, Taggart sought to be dismissed from the state court litigation. The creditors objected and the state court judge refused to dismiss Taggart, finding that he was a necessary party. The parties agreed, however, not to pursue a money judgment against him. The creditors prevailed in the state court action and the sale was unwound. The LLC agreement that Taggart had breached included a fee shifting provision.

The creditors contended that Taggart's liability for post-petition attorneys' fees had not been discharged in his bankruptcy case because he had "returned to the fray" of the litigation post-petition.[2] The state court, which has concurrent jurisdiction with the bankruptcy court to determine whether a debt had been discharged, agreed with the creditors.

Taggart reopened his bankruptcy proceedings, asserting that the bankruptcy court should impose sanctions on the creditors for seeking to collect on a discharged claim.

The bankruptcy court, however, agreed with the state court that the creditors were not barred from pursuing post-petition fees because Taggart's post-bankruptcy participation in the state court litigation (which the creditors had demanded, insisting Taggart was a necessary party) fell outside his bankruptcy discharge injunction.

After separate appeals in both systems, both the state appellate court and federal district court found that the creditors had, in fact, violated Taggart's discharge injunction. On remand, the bankruptcy court found that the creditors had knowingly and willfully violated the discharge injunction and entered an order holding them in contempt and awarded sanctions.

The Appeal

On appeal, the bankruptcy appellate panel and the U.S. District Court for the Ninth Circuit both reversed the bankruptcy court's contempt order. The Ninth Circuit began by analyzing the standard for finding a party in civil contempt.[3] The court held that Taggart had the burden of showing by clear and convincing evidence that the creditors violated a specific and definite order of the bankruptcy court. The burden then shifted to the creditors to demonstrate why they were unable to comply with that order.[4]

The Ninth Circuit has adopted a two-part test for determining the propriety of a contempt sanction in the context of violating a discharge injunction. "To justify sanctions, the movant must prove that the creditor (1) knew the discharge injunction was applicable and (2) intended the actions which violated the injunction." [5]

The Ninth Circuit held that only the first prong of the test was at issue in this case. The Ninth Circuit held that a creditor's good faith belief excuses a discharge violation, "even if the creditor's belief is unreasonable." [6]

According to the Ninth Circuit, the issue is not only whether the creditor knew of the discharge injunction, but also whether the creditor knew "the discharge injunction [was] applicable to their claims." Thus, if the creditor in good faith believed that the discharge injunction does not apply to their claim, then the creditor cannot be held in contempt, "even if the creditor's belief is unreasonable."

Therefore, without reaching the question of whether the creditors had actually violated the discharge injunction, the Ninth Circuit held that the creditors could not be liable for sanctions because they had a good faith belief that Taggart's obligation to pay attorneys' fees had not been discharged in his bankruptcy case.

Briefing to the Supreme Court

Taggart appealed the Ninth Circuit's decision arguing that insulating a creditor from contempt after its violation of a debtor's discharge injunction merely because the creditor had a "good faith belief, even if unreasonable" that the injunction did not apply to its claim eviscerates the discharge injunction's relevance.[7] According to Taggart, whether a contemnor acted in "good faith" is irrelevant to the Supreme Court's longstanding rules for civil contempt.[8]

The creditors effectively countered that bankruptcy was different than other civil litigation. In ordinary civil litigation, an injunction is carefully crafted by a court to be clear and unambiguous and to address a specific activity. In bankruptcy, however, disputes sometimes arise about whether a discharge injunction applies to a particular claim because not all claims are discharged in bankruptcy.[9]

Because disputes may arise about whether a claim has been discharged, the Bankruptcy Code does not specify a particular remedy for the situation in which a creditor attempts to collect a debt in violation of a discharge injunction. Rather, the Bankruptcy Code vests the bankruptcy judge with discretionary authority to issue any order, process or judgment that is "necessary and appropriate" to enforce the discharge injunction (or any of its orders).[10]

This contrasts with other Bankruptcy Code sections that provide a specific remedy if they are violated, demonstrating that Congress intended a more flexible standard for violators of the discharge injunction.[11]

Taggart dismissed the creditors' attempt to draw a distinction between bankruptcy and other civil litigation. Taggart noted that the McComb court held that anyone uncertain of an injunction's scope is free to seek clarification from the issuing court.[12] If a party fails to do so, then that party bears the risk of violating the injunction and must compensate the protected party for losses or damages it sustains.[13] During oral argument, Taggart's attorney noted that Federal Rule of Bankruptcy Procedure 4007 contemplates just such a mechanism.[14]

The creditors noted that the state court and the bankruptcy court have concurrent jurisdiction to determine whether a debt has been discharged. At one point, the creditors had an order that their action against Taggart for attorneys' fees was not subject to his discharge injunction. Therefore, the creditors asserted they had complied with the standard proposed by Taggart and cited in McComb, even if the order was later overturned.

Critically for the creditors, they also cited the significance of contempt sanctions against an attorney. Contempt of court is a serious sanction and severe remedy, designed for a situation in which a person deliberately disobeys a court. The creditors asserted that contempt should be used sparingly because of its severity.

The creditors asserted that Taggart's argument that the creditors should be subject to contempt merely because they were aware that Taggart had received a bankruptcy discharge when they sought attorneys' fees effectively created a strict liability standard for contempt sanctions, which was inappropriate.

Oral Argument

Chief Justice John Roberts appeared to empathize with Taggart's arguments that creditors seeking a remedy against a debtor should first check with the bankruptcy court stating:

I don't see why it is so hard for a creditor, if he has any doubt to go ... [back to bankruptcy court], instead of ... going after the newly released debtor who ... is supposed to get a fresh start and all of a sudden there are the same people who were hounding him before.

The attorney for the creditors argued that requiring creditors to return to bankruptcy court would have a chilling effect on collection efforts because Bankruptcy Rule 4007 requires that a creditor commence

an adversary proceeding. Moreover, even if the creditor complied with Bankruptcy Rule 4007, the debtor would be required to respond to the complaint and likely incur attorney fees to answer the claim.

Thus, according to the creditors, compliance with Bankruptcy Rule 4007 did not provide a debtor with any additional benefit than litigating the dischargeability of its debt in state court, as had been done in this case.

The other justices, however, seemed to side with the creditors' arguments, agreeing that contempt is a severe sanction and that courts should consider the circumstances and a litigant's good faith, where appropriate. Justice Samuel Alito asked Taggart's counsel, "What is the justification for holding somebody in contempt for doing something that two [] courts have held was not a violation? ... Even if those two courts turned out to be wrong."

In response, Taggart's attorney relied heavily on the expense incurred by a debtor when a creditor erroneously attempts to collect a discharged debt. Rather than demand that contempt automatically be imposed on parties who violate the discharge injunction, however, Taggart's attorney stated, "[o]ur position is that if the discharge is violated, then under Section 105 [of the Bankruptcy Code] a court may impose a remedial order to remedy the violation. It's in the court's discretion."

He emphasized the need to restore the benefits of the discharge to the debtor. Therefore, while Taggart's position was that "good faith" should not be considered by a court when determining if a creditor had violated the discharge injunction, that did not mean that a court must impose contempt sanctions for such violation. Rather, Taggart's position evolved such that if the discharge injunction is violated, then the debtor should (at least) be made whole by the violating creditor.

Takeaways

None of the justices — nor even the creditors — appeared to agree with the Ninth Circuit's holding that a creditor's good faith belief excuses a discharge violation, "even if the creditor's belief is unreasonable." Thus, it would seem the court will remand this case to apply a new standard.

Given the justices' questioning and the evolution of the parties' positions during oral argument, it also would seem that a creditor's good faith belief will be a part of the standard that courts must apply when determining sanctions for violations of a discharge injunction.

James T. Bentley is special counsel with Schulte Roth & Zabel LLP.

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[1] There are exceptions to this general rule set forth in the Bankruptcy Code, but they are not applicable here.

[2] The "return to the fray" exception to the discharge injunction is a court-made rule whereby post-petition attorney fee awards are deemed excepted from discharge when the debtor voluntarily pursues a whole new course of litigation or voluntarily continues to pursue prepetition litigation post-bankruptcy.

(i.e., returns to the fray). See *In re Ybarra*, 424 F.3d 1018 (9th Cir. 2005).

[3] *Lorenzen v. Taggart* (*In re Taggart*), 888 F.3d 438, 442 (9th Cir.).

[4] *Id.* at 443 (citations omitted).

[5] *Id.* (citation omitted).

[6] *Id.* at 444 (citations omitted).

[7] The Circuit split the Supreme Court is attempting to resolve arose from, among other cases, *In re Hardy*, 97 F.3d 1384 (11th Cir. 1996) ("[w]hether the Respondents knew the discharge was 'invoked' is a simple fact-based inquiry" [and that inquiry] does not allow for the subjective belief, good faith or otherwise....")

[8] See *McComb v. Jacksonville Paper*, 336 U.S. 187 (1949) (good faith is irrelevant when effecting compliance with an injunction). The Department of Justice appeared as an amicus curie in support of neither party. The DOJ argued for a slightly different standard to be applied by courts than the one proposed by the Creditors. Rather than considering whether a creditor had acted in "good faith" when determining whether to hold it in contempt, the DOJ argued that a court should impose contempt only if there is an objectively fair ground of doubt that the conduct at issue violated the discharge injunction. Counsel for the Creditors noted during his oral argument that "We don't think that there's much daylight at all between our test and the government, particularly in this case, where good faith is undisputed...."

[9] See e.g., 11 U.S.C. Section 727, 1141.

[10] 11 U.S.C. § 105(a).

[11] See 11 U.S.C. § 362(k) (individual injured by willful violation of automatic stay "shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.").

[12] 336 U.S. at 192.

[13] *Id.* at 191, 193.

[14] See Fed. R. Bankr. P. 4007 (Determination of Discharge of Debt).