Can Obeying a Court Order Prevent Contempt Sanctions?

CASE AT A GLANCE

Let's say you sue a defendant in state court for injunctive relief. The defendant then files bankruptcy and receives a discharge. Then, the state court says you can proceed, despite the discharge. And so you do. Then, the defendant seeks contempt sanctions in bankruptcy court for a discharge injunction violation. Can you be sanctioned, if the state court was wrong? Such is the essence of what's before the Supreme Court in *Taggart v. Lorenzen.*

Taggart v. Lorenzen
Docket No. 18-489

Argument Date: April 24, 2019
From: The Ninth Circuit

by Donald L. Swanson
Koley Jessen P.C., L.L.O., Omaha, NE

INTRODUCTION

Taggart v. Lorenzen is a fascinating case. And it's obvious that the issues are contentious, given the numerous reversals that have already occurred in both state and federal courts.

ISSUES

The formal question before the Court is:

> Whether, under the Bankruptcy Code, a creditor's good-faith belief that the discharge injunction does not apply precludes a finding of civil contempt.

Practically, however, the issue is this: if you act in reliance on a state court order that is subsequently reversed, can you be held in contempt for violating the bankruptcy discharge injunction?

FACTS

Sherwood Park Business Center, LLC, and its members sued Bradley Taggart in state court because Taggart transferred his membership interest in Sherwood to another LLC entity. The plaintiffs sought to unwind that transfer and to expel Taggart from the company. Taggart counterclaimed for attorney's fees.

On the day before trial, Taggart filed Chapter 7 bankruptcy, in which he received a discharge.

After Taggart's discharge, Sherwood resumed the state court lawsuit, which went to trial without Taggart's participation—but with his attorney present. The state court ruled in Sherwood's favor by unwinding Taggart's transfer and enforcing the right of first refusal held by other Sherwood members.

Then, here's where the issue arose: the same plaintiffs sued Taggart in state court to recover attorney's fees they incurred after Taggart received his discharge. Simultaneously, they asked the state court to determine whether the discharge injunction prevented their fee request, citing this proposition from *In re Ybarra,* 424 F.3d 1018 (9th Cir. 2005):

> a debtor cannot, after being "freed from the untoward effects of the contracts" through a discharge, voluntarily "return to the fray and to use the contract as a weapon" without allowing "the same weapon to be used against him."

Taggart argued that he did not voluntarily return to any fray.

The state court ruled that Taggart *had* "returned to the fray," so the discharge injunction did not apply. Ultimately, the state court awarded plaintiffs a judgment against Taggart for the attorney's fees they incurred after entry of his discharge. Taggart appealed to the state appellate court, which reversed the "returned to the fray" ruling.

Meanwhile, Taggart reopened his bankruptcy and moved to hold his state court opponents in contempt for violating the discharge injunction. On December 9, 2011, the bankruptcy court denied Taggart's contempt motion, finding no error in the state court's actions. Taggart appealed to the U.S. District Court, which reversed and remanded the bankruptcy court ruling, declaring that Taggart had not returned to the fray.

On November 26, 2014, the state appellate court declared that Taggart had not "returned to the fray" and reversed the state court's attorney's fees award against Taggart.

The bankruptcy court, on remand from the district court, then found that Taggart's opponents willfully violated the discharge injunction and entered orders of contempt and sanctions against

them. Taggart's opponents next appealed to the Ninth Circuit Bankruptcy Appellate Panel (BAP) (instead of the district court, which had already ruled against them). On April 12, 2016, the Ninth Circuit BAP rewarded appellants' forum selection decision by reversing the bankruptcy court's contempt and sanctions orders, Taggart then appealed to the Ninth Circuit Court of Appeals, which on April 23, 2018, affirmed the BAP reversal

Taggart then appealed to the Supreme Court, which granted certiorari on January 4, 2019.

CASE ANALYSIS

To fully understand *Taggart* and its discussions about a "return to the fray," we need to understand the Ninth Circuit's prior case of *In re Ybarra,* 424 F.3d 1018 (9th Cir. 2005). The *Taggart* issues and rationale are an extension of what happened in *In re Ybarra.*

Here are the *In re Ybarra* facts and litigation history. Nancy Ybarra sued her employer, Rockwell International Corporation, in state court for employment discrimination. Then, Ybarra filed bankruptcy but failed to schedule her claim against Rockwell. Ybarra's Chapter 7 trustee learned of the suit and agreed to sell Ybarra's claim to Rockwell for $17,500. The bankruptcy court approved the sale over Ybarra's objection. Then, Rockwell obtained a dismissal of Ybarra's lawsuit. In response, Ybarra scheduled her claim against Rockwell as an exempt asset. Rockwell objected to the exemption claim; the bankruptcy court sustained Rockwell's objection, the Ninth Circuit BAP reversed and granted the exemption, and the Ninth Circuit Court of Appeals affirmed the BAP.

On remand, the bankruptcy court gave Ybarra the option of either accepting $17,500 in full satisfaction of the exempt claim against Rockwell, or taking ownership of and pursuing the lawsuit. Ybarra elected to take ownership, and she persuaded the state court to revoke the dismissal. Then, the state court granted summary judgment in favor of Rockwell, who subsequently moved for an award of attorney's fees against Ybarra. The state court awarded Rockwell fees of $456,884.03. Ybarra appealed and the California Court of Appeals affirmed.

Meanwhile, Ybarra received a bankruptcy discharge. So, Rockwell sought bankruptcy court authority to enforce its attorney's fees award against Ybarra. The bankruptcy court held that attorney's fees incurred after Ybarra filed bankruptcy (in the amount of $159,030.78) were not discharged, and Rockwell could collect such amount without violating the discharge injunction. Ybarra appealed to the Ninth Circuit BAP, which reversed, declaring the entire attorney's fees award to be discharged. Rockwell appealed, again, and the Ninth Circuit Court of Appeals reversed, affirming the bankruptcy court's attorney's fees allowance.

Rockwell argued to the the Ninth Circuit that, while Ybarra's Chapter 7 discharge released her from personal liability for pre-bankruptcy debts, Rockwell's $159,030.78 claim for attorney's fees arose after bankruptcy filing—so, such claim could not be discharged.

The Ninth Circuit agreed with Rockwell, citing *Siegel v. Federal Home Loan Mortgage Corp.,* 143 F.3d 525 (9th Cir. 1998), in which a lienholder obtained relief from stay to foreclose its lien. In *Siegel*: (1) two months before receiving a discharge, the debtor (Siegel) sued the lienholder for breach of duties; (2) the lienholder won on summary judgment and obtained an attorney's fees award against Siegel; (3) on appeal, Siegel insisted the attorney's fees award had been discharged in bankruptcy, but the Ninth Circuit disagreed because (emphasis added):

> After being "freed from the untoward effects of the contracts he had entered into" through the discharge, Siegel chose to "***return to the fray*** and to use the contract as a weapon";
>
> While Siegel's bankruptcy protected him from the results of his past acts, it did not give him carte blanche to go out and commence new litigation about the contract without consequences; and
>
> Consequently, it was "perfectly just, and within the purposes of bankruptcy, to allow the same weapon to be used against" Siegel.

The Ninth Circuit explained its *In re Ybarra* ruling, further, as follows (emphasis added):

> Post-petition attorney's fee awards are not discharged where, post-petition, the debtor voluntarily pursues a whole new course of litigation or voluntarily "***returns to the fray***";
>
> After filing bankruptcy, Ybarra "***returned to the fray***" by litigating her exemption claim for the suit against Rockwell, refusing Rockwell's $17,500 settlement offer, obtaining a set-aside of the prior dismissal of her claim against Rockwell, and litigating her claim through a loss on summary judgment; and
>
> Thus, Rockwell's $159,030.78 award for attorney's fees incurred post-petition was not discharged in the bankruptcy because Ybarra's actions were sufficiently voluntary and affirmative to qualify as "***returning to the fray***."

In sum, the effect of *In re Ybarra* on *Taggart* is this: The state court, in *Taggart,* applied *In re Ybarra's* "returned to the fray" analysis—and got it wrong. The creditor in *Taggart* relied upon the state court's subsequently-reversed ruling. And so the *Taggart* question is whether the creditor's reliance on the subsequently-reversed ruling should, somehow, mitigate or eliminate the contempt results that followed.

In *Taggart,* the Ninth Circuit held that Taggart's opponents "could not be held in contempt because they did not knowingly violate the discharge injunction." The Ninth Circuit reasoned that a contempt sanction in the context of a discharge injunction is subject to a two-part test: "the movant must prove that the creditor (1) knew the discharge injunction was applicable and (2) intended the actions which violated the injunction." The Ninth Circuit further found that "[t]o satisfy the first prong, knowledge of 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." The Ninth Circuit continued, "additionally, 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." Finally, the Ninth Circuit concluded, "in this case, the bankruptcy court abused its discretion by…applying an incorrect rule of law." It held that "a good faith belief that the discharge injunction was inapplicable to the Creditors' claims was irrelevant for purposes of determining whether there was a 'knowing' violation of the discharge injunction."

SIGNIFICANCE

A reversal of the Ninth Circuit's ruling would put legal practitioners in a dilemma. Practitioners would not be able to rely on a state court ruling—because that ruling might be reversed on appeal or overridden by a bankruptcy court on a contempt motion. Practitioners would need, instead, to reopen the bankruptcy case and seek an advisory opinion from the bankruptcy court on whether the discharge injunction would be violated by proposed actions, but the Bankruptcy Code and Rules make no provision or procedure for such an advisory opinion. The only remedy in a close case, therefore, is to either proceed in state court and take your chances on a potential contempt action in bankruptcy court, or abandon the proposed action.

The Ninth Circuit's ruling is, apparently, a minority of one. According to Taggart's Petition for a Writ of *Certiorari,* the Ninth Circuit's ruling is in conflict with all other circuit courts, bankruptcy appellate panels, and bankruptcy courts that have addressed the matter.

In his petition, Taggart notes that the First Circuit, in *In re Pratt,* 462 F.3d 14 (1st Cir. 2006), held that a creditor's violation of the discharge injunction was actionable despite the lack of "bad faith" and that "the standard for a willful violation" is met "if there is knowledge of the stay and the defendant intended the actions which constituted the violation." According to the First Circuit, when a willful violation occurs, the bankruptcy debtor is entitled to recover "compensatory damages, together with other appropriate relief under Bankruptcy Code § 105(a)." The Fourth Circuit, in *In re Fina,* 550 F. App'x 150 (4th Cir. 2014) (*per curiam*), held that "contempt sanctions" in the discharge context are controlled by a "two-part test": "(1) whether the creditors violated the injunctions, and (2) whether they did so willfully." The Fourth Circuit added that the "willfulness prong requires only that the acts taken in violation of the injunction be intentional" so that "a good faith mistake is generally not a valid defense."

The Eleventh Circuit, in *In re Hardy,* 97 F.3d 1384 (11th Cir. 1996), held that Section 105 authorizes relief for discharge violations, irrespective of a creditor's good faith: "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."

Two bankruptcy appellate panels are in accord with the Eleventh, First, and Fourth Circuits: *see In re Martin,* 474 B.R. 789 (B.A.P. 6th Cir. 2012), and *In re Culley,* 347 B.R. 115 (B.A.P. 10th Cir. 2006), and dozens of bankruptcy court opinions, nationwide, are contrary to the Ninth Circuit's position. *See* pages 19–21 of the Petition for a Writ of *Certiorari* for a listing of pertinent cases.

The Third Circuit notes that at the rehearing stage below, one of the respondents argued that the Ninth Circuit does not "stand alone" in its position, suggesting that the Third Circuit holds a similar position, citing *In re Ben Franklin Hotel Assocs.,* 186 F.3d 301, 309 (3d Cir. 1999). "This assertion is twice curious," Taggart argues because (1) it "supports, not diminishes, the need for this Court's immediate review," and (2) the Third Circuit actually held that the bankruptcy court did not "abuse [its] discretion" in declining contempt in light of the "unusual facts" before it.

Respondents argue that the Ninth Circuit's ruling should be affirmed for a number of reasons. First, respondents claim the Bankruptcy Appellate Panel properly concluded that they had not violated the discharge injunction at all and that they "should be praised, not sanctioned," for following correct procedures. Respondents further argue that the Bankruptcy Appellate Panel also properly concluded that, even if the discharge injunction had been violated, the bankruptcy court applied the wrong legal standard for determining respondents' liability for contempt.

The Ninth Circuit did not reach the question of whether respondents had violated the discharge injunction but properly held, instead, that respondents could not be liable for sanctions because of their good faith belief that attorney's fees obligations were not discharged. Respondents argue that the Ninth Circuit's ruling is not contrary to rulings in other jurisdictions on the question presented. For example, respondents assert *In re Hardy* is distinguishable and has been abrogated by statute.

According to respondents, imposing contempt sanctions is "doubly discretionary (at both the liability and damages stages)," so that "context-dependent outcomes are expected" and the Ninth Circuit's approach to the question presented is plainly correct, whereas the petitioner's approach "would write language into the Bankruptcy Code that does not appear there."

Petitioner responds that the Ninth Circuit's ruling should be reversed. He contends that the Ninth Circuit's "good faith belief" standard violates traditional rules of civil contempt because, (1) the Supreme Court determined long ago that "good faith" is irrelevant to compliance with an injunction, (2) contempt is designed to enforce a decree—not focus on the violator's state of mind, (3) if a party fails to seek guidance from the issuing court, it assumes the risk of mistakes and is responsible for damages, (4) the discharge injunction is activated by both statutory directive and judicial decree—it strictly prohibits collection of discharged debts and applies irrespective of a state of mind, and (5) Federal Bankruptcy Rule 4007 provides a specific procedure for determining whether a debt is discharged or not, the violation of which is inexcusable. Petitioner argues further that the "good faith belief" is incompatible with the Bankruptcy Code because, (1) Congress granted bankruptcy courts authority in Section 105 to enforce the Code's provisions and secure the debtor's fresh start, (2) nothing in law or logic categorically precludes

remedial contempt where a party violated debtor's rights in good faith, (3) Congress proved it knew how to impose good-faith requirements where it so wished but gave "no hint of a general good-faith defense for discharge violations," (4) instead, Congress granted a cause of action for automatic-stay violations (11 U.S.C. 362(k)) that does not insulate good-faith errors, and (5) stay violations and discharge violations are cut from the same cloth.

Petitioner warns that the Ninth Circuit's "good faith belief" has the wrongful effects of creating subjective-intent requirements that are difficult to administer; encouraging pretextual excuses and protracted litigation; undercutting a debtor's ability to protect its rights; and imposing costs of creditor error upon debtors, when creditors are in a better position to pay for the harm they wrongfully inflict.

Turning to the Bankruptcy Code's history, petitioner argues the "good faith belief" standard is contrary to this history because, for many decades and in the vast majority of jurisdictions, a creditor's state of mind is irrelevant to remedial contempt, and despite Congress's many amendments to the Bankruptcy Code, it has yet to cast doubt on this sound practice.

The amici curiae in *Taggart* come in on petitioner's side in seeking reversal of the Ninth Circuit's ruling. Here are flavors from the amici briefs. The National Consumer Bankruptcy Rights Center and the National Association of Consumer Bankruptcy Attorneys argues "Multiple circuits and lower courts have followed a decades old rule that a creditor who has knowledge of a bankruptcy and attempts to collect a discharged debt, violates the discharge injunction. There is no good faith exception."

A group of two retired bankruptcy judges and five law professors asserts that:

> The Ninth Circuit ruling should be reversed because, (1) "the history and structure of the discharge provisions" in the Bankruptcy Code "demonstrate that Congress did not intend to permit creditors to disregard the discharge based on…a subjective, good faith belief," (2) it "will permit abusive creditor conduct" and "encourage the filing of claims on discharged debt by aggressive creditors" who will feign ignorance and, thereby, avoid contempt, and (3) it impairs the discharge's effectiveness in achieving the goals and purposes Congress has established.

Ultimately, the practical significance of *Taggart* is this: if a party cannot rely on a state court ruling, before appeal, concerning the effect of a bankruptcy discharge on subsequent litigation, then the party will need to seek permission from the bankruptcy court instead of the state court—and there is no provision for doing so in the Bankruptcy Code or Rules.

Donald L. Swanson is a shareholder with Koley Jessen P.C., L.L.O. He has been practicing bankruptcy law for many years (more than he cares to admit) and publishes a blog on bankruptcy and mediation topics at www.mediatbankry.com. He can be reached at 402.343.3726.

PREVIEW of United States Supreme Court Cases 46, no. 7 (April 15, 2019): 50–53. © 2019 American Bar Association

ATTORNEYS FOR THE PARTIES

For Petitioner Bradley Weston Taggart (Daniel L. Geyser, 214.800.2660)

For Respondent Shelley A. Lorenzen (Michael B. Kimberly, 202.263.3000)

AMICUS BRIEFS

In Support of Petitioner Bradley Weston Taggart

National Consumer Bankruptcy Rights Center (Tara Twomey, 831.229.0256)

Retired Judges and Law Professors (David R. Kuney, 301.299.9544)

In Support of Neither Party

United States (Noel J. Francisco, Solicitor General, 202.514.2217)