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Creditor's "Unreasonable" but "Good Faith" Belief as a Defense to an Alleged Discharge Violation

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More than 740,000 bankruptcy petitions were filed in 2017 by individuals with debts that are predominantly consumer in nature. Through November last year, there were over 700,000 new filings. From these numbers, lawsuits over alleged violations of bankruptcy discharges are frequently in the news, particularly because some of those lawsuits resulted in big sanctions. See, e.g., First State Bank of Roscoe v. Stabler, 247 F. Supp. 3d 1034, 1046 (D.S.D. 2017) (bank and its principal were jointly and severally liable to pay $159,605 in attorney's fees plus individually liable to pay $25,000 in punitive damages). Attorneys have also borne the brunt of those sanctions. See In re Jon-Dogar Marinesco, Case No. 09-35544 (CGM) (Bankr. S.D.N.Y. Dec. 1, 2016) (compensatory and punitive damages awarded against two law firms).

For consumer debtors, the "principal purpose" of the Bankruptcy Code is a "fresh start." This means a "new opportunity in life and a clear field of future effort, unhampered by the pressure and discouragement of preexisting debt." Grogan v. Garner, 498 U.S. 279, 286 (1991). To achieve that purpose, debtors "discharge" most prepetition debts under section 727(b) of the Bankruptcy Code. An injunction under section 524(a)(2) of the Bankruptcy Code prohibits activity to collect discharged debts. See Bessette v. Avo Fin. Servs., Inc., 230 F.3d 439, 444 (1st Cir. 2000).

Congress has not designated a specific sanction for a violation of a discharge injunction. However, bankruptcy courts are vested with powers to protect their jurisdiction. Under section 105(a) of the Bankruptcy Code, a bankruptcy court may "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title" and may "tak[e] any action or mak[e] any determination necessary or appropriate" to "enforce or implement court orders or rules." 11 U.S.C. § 105(a). Hence, a bankruptcy court may use the contempt power to protect its jurisdiction and address violations of the discharge injunction under section 105(a). See Walls v. Wells Fargo Bank, N.A., 276 F.3d 502, 508 (9th Cir. 2002) (contempt is the "traditional remedy" and perhaps the sole remedy for discharge violations).

Discharge violations often arise when a creditor takes action that may be considered an effort to collect on a discharged debt. To prove a violation, the debtor as "the moving party has the burden of showing by clear and convincing evidence that the [creditor] violated a specific and definite order of the court." Lorenzen v. Taggart (In re Taggart), 888 F.3d 438, 443 (9th Cir. 2018). Clear and convincing evidence is evidence that "instantly tilt[s] the evidentiary scales in the affirmative when weighed against the evidence [the nonmoving party] offered in opposition." In re Taggart, 548 B.R. at 288 n.11 (citation omitted). Some arguments turn on a creditor's intentions and awareness of the debtor's discharge, which can be an important consideration if the underlying conduct was done innocently. However, not all courts agree that these issues should be considered at all. The United States Supreme Court will now decide.

The Emergence of the Good-Faith Defense

There is an argument that a creditor should be shielded from a discharge violation by its good-faith belief that the discharge injunction does not apply to its action relating to a discharged debt. The argument may apply even if the belief was "unreasonable." Now, the Supreme Court will decide whether to permit this defense, following its grant of certiorari in Taggart. Taggart involves a dispute over interests in a limited liability company. On the eve of a state court trial, Mr. Taggart filed for Chapter 7 bankruptcy. The trial was therefore stayed, and Mr. Taggart ultimately received a discharge of the claim. However, the state court refused to dismiss Mr. Taggart from the litigation, although the parties agreed not to pursue a money judgment against him. Nonetheless, the plaintiffs sought attorney's fees from Mr. Taggart, alleging his post-bankruptcy participation in the case fell outside the discharge injunction. In defense, Mr. Taggart moved to reopen his bankruptcy to hold his creditors in contempt for violating his discharge injunction.

The bankruptcy court agreed with Mr. Taggart and found the plaintiffs in contempt because they were aware of the discharge and intended their actions. The Bankruptcy Appellate Panel reversed because the bankruptcy court found that subjective or good-faith beliefs were irrelevant. The Ninth Circuit Court of Appeals affirmed that ruling, deciding that creditors could not be in contempt if they believed in good faith that the discharge injunction did not apply. The court of appeals reasoned that a creditor's good-faith belief excuses a discharge injunction "even if the creditor's belief is unreasonable." Taggart, 888 F.3d at 444.

The Rejection of the Good-Faith Defense

Other courts disagree with this reasoning and refuse to allow consideration of the creditor's intent and awareness. In In re Hardy, 97 F.3d 1384, 1390 (11th Cir. 1996), the Eleventh Circuit held 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." Likewise, in In re Pratt, 462 F.3d 14, 19–21 (1st Cir. 2006), the First Circuit held that the creditor's violation was actionable despite the lack of "bad faith." The Fourth Circuit reached a similar conclusion in In re Fina, 550 F. App'x 150, 154 (4th Cir. 2014), holding a "good faith mistake is generally not a valid defense."

Now the Supreme Court will step into the breach. The Court's rejection of a "good-faith mistake" defense would certainly solidify the debtor's "fresh start." However, voiding this defense would subject creditors to strict liability for otherwise innocent activity. In addition, although a creditor's good-faith intent may remain a factor for determining sanctions, see In re Szenes, 515 B.R. 1, 7–8 (Bankr. E.D.N.Y. 2014) (mere showing that the actions were deliberate is not sufficient for punitive damages; rather, the actions must have been taken with "either malevolent intent or a clear disregard and disrespect of the bankruptcy laws"), damages awards, including shifting attorney's fees, would remain available where there is liability. As noted, these risks extend to creditors' counsel personally.

Fortunately, there should soon be a more uniform standard of accountability. As of this writing, opening briefs have been filed, amici are weighing in with their policy arguments, and the Supreme Court will hear argument on April 24, 2019. The Solicitor General has also expressed interest, requesting argument due to ambiguity over the application of the discharge order to debts owed to the government. Under the circumstances, the outcome is uncertain, but we can predict that this will be an important benchmark for consumer creditors and debtors as well as the bankruptcy judges who decide these issues. This is equally so for the lawyers who represent those parties.