LAVISH SPENDING AS EVIDENCE OF "WILLFUL TAX EVASION": HOW THE NINTH CIRCUIT'S REQUIREMENT OF "SPECIFIC INTENT" IN *HAWKINS* CREATES A CIRCUIT SPLIT AND FACILITATES ABUSE OF THE BANKRUPTCY SYSTEM

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INTRODUCTION

It is no secret that those with wealth in America often get to play by a different set of rules.[1] It should come as no surprise that this holds true in the context of bankruptcy as well.[2] The Ninth Circuit's recent holding in *Hawkins v. Franchise Tax Board* effectively endorsed such treatment by refusing to find that Mr. Hawkins's "lavish lifestyle," which continued well after he became aware of substantial tax obligations and after he had expressed the intent to discharge said obligations through bankruptcy, "constituted [evidence of] a willful attempt to evade taxes."[3] Instead, the Ninth Circuit remanded the case to be reconsidered under a

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1. In a highly publicized Texas case, a teen from a wealthy family, said to be "a victim of 'affluenza'" and thus incapable of appreciating the consequences of his actions, was sentenced to ten years probation and no jail time after killing four people while driving drunk. *See* Dana Ford, *Judge Orders Texas Teen Ethan Couch to Rehab for Driving Drunk, Killing 4*, CNN (Feb. 6, 2014, 9:05 PM), http://www.cnn.com/2014/02/05/us/texas-affluenza-teen/. In the tax context, wealthy taxpayers receive preferential treatment in the form of lower taxes on capital gains than "ordinary income." Even after the rate on capital gains increased from fifteen percent to twenty percent in 2013, Warren Buffett says he would still "probably be the lowest paying taxpayer [as a percentage of income] in the office." Chris Isidore, *Buffett Says He's Still Paying Lower Tax Rate than His Secretary,* CNN MONEY (Mar. 4, 2013, 11:20 AM), http://money.cnn.com/2013/03/04/news/economy/buffett-secretary-taxes/.

2. See *infra* Part III.A of this Note for a discussion of various aspects of bankruptcy law that favor the rich.

3. Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 769 F.3d 662, 665–66, 670 (9th Cir. 2014).

standard of "specific intent."[4] By "requir[ing] a showing of specific intent to evade [or defeat such] tax,"[5] the Ninth Circuit "create[d] a circuit split and turn[ed] a blind eye to the shenanigans of the rich."[6]

This Note will advocate for the United States Supreme Court to grant certiorari in order to resolve the circuit split. In doing so, the Court should adopt the test used by the Tenth Circuit in *In re Vaughn*, which held that the "mental state requirement" of willful tax evasion is satisfied when the following three elements are present: "1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty."[7] The policy of providing distressed debtors with a "fresh start" through bankruptcy should not extend to allowing wealthy taxpayers who have become financially insolvent to continue living the lifestyle they are accustomed to while at the same time abusing the bankruptcy system to escape their known and substantial tax obligations.[8]

This Note will begin with a brief background of the United States Bankruptcy Code ("the Code"), including the forms of relief offered, the general presumption that a debt is dischargeable, and the operation of section 523 of the Code to provide exceptions to the presumption that all debts are dischargeable.[9]

Part I will continue with a brief progression of Mr. Hawkins's case from the United States Bankruptcy Court for the Northern District of California, which held that Mr. Hawkins's tax obligations were excepted from discharge under section 523(a)(1)(C), to the Ninth Circuit's reversal of the bankruptcy and district courts' holdings, finding that the lower courts did not apply the appropriate standard, namely, that "acts be taken with the specific intent to evade the tax" in order for the exception from discharge to apply.[10]

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4. *Id.* at 670.
5. *Id.* at 669.
6. *Id.* at 671 (Rawlinson, J., dissenting).
7. Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1181 (10th Cir. 2014) (quoting Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 546 (Bankr. D. Colo. 2011), *aff'd*, No. 12-cv-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2013), *aff'd*, 765 F.3d 1174) (applying a standard for "willfulness" first condoned by the Fifth Circuit in *Bruner v. United States* (*In re* Bruner), 55 F.3d 195, 200 (5th Cir. 1995), and later adopted by the Eleventh Circuit in *Griffith v. United States* (*In re* Griffith), 206 F.3d 1389, 1396 (11th Cir. 2000)).
8. *See Hawkins*, 769 F.3d at 670–71 (Rawlinson, J., dissenting); *see also infra* note 15 and Part II.B.1.
9. *See, e.g.*, 11 U.S.C. § 523(a)(1)(C) (2012) (stating that an individual debtor is not discharged from any debt if the debtor "willfully attempted" to avoid such tax).
10. *Hawkins*, 769 F.3d at 670 ("[W]e vacate the judgment and remand so that the courts can reanalyze the case using the specific intent standard."); Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R 225, 228 (Bankr. N.D. Cal. 2010) ("[The bankruptcy court]

Part II will juxtapose the position taken by the Ninth Circuit in *Hawkins* with that taken by the Tenth Circuit in *In re Vaughn*, a case which was decided only weeks before the Ninth Circuit decided *Hawkins*.[11]

Finally, Part III of this Note will examine the policy reasons for adopting the position taken by the Tenth Circuit in *Vaughn*, which did not require a "specific intent to evade . . . tax[es]"[12] in order to trigger section 523(a)(1)(C)'s exception from discharge,[13] viewed in light of the disparity between how wealthy and middle- and lower-class debtors are treated in the bankruptcy process.

I. THE UNITED STATES BANKRUPTCY SYSTEM AND *HAWKINS*, FROM THE BANKRUPTCY COURT'S FINDING OF WILLFUL TAX EVASION, TO THE NINTH CIRCUIT'S REVERSAL

A. The United States Bankruptcy Code

An underlying principle behind the Bankruptcy Code, Title 11 of the United States Code,[14] is to provide debtors who are unable to pay their creditors with a "fresh start,"[15] either "by liquidating assets to pay their debts or by creating a repayment plan."[16] "[T]he three main chapters of the Bankruptcy Code . . . are Chapter 7, Chapter 11, and Chapter 13[,] . . . [and] [f]ederal courts have exclusive jurisdiction over bankruptcy cases."[17]

determine[d] that he attempted to evade collection of tax by dissipating his assets on unnecessary and unreasonable expenditures while he knew he owed taxes and knew he was insolvent."), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662.

11. *In re Vaughn*, 765 F.3d 1174. The Tenth Circuit actually cited to the district court's opinion in *Hawkins* regarding the correct standard to be applied. *See id.* at 1181 (citing *Hawkins*, 447 B.R. at 300).

12. *Hawkins*, 769 F.3d at 669.

13. *In re Vaughn*, 765 F.3d at 1182 (finding willfulness where appellant claimed to have innocently relied on his tax advisor's advice).

14. *Process—Bankruptcy Basics*, U.S. CTS., http://*www*.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Process.aspx (last visited Nov. 14, 2015).

15. BRIAN A. BLUM, EXAMPLES AND EXPLANATIONS: BANKRUPTCY AND DEBTOR/CREDITOR 99–100 (4th ed. 2006) ("The goal of long-term *rehabilitation* of the debtor is commonly referred to as the 'fresh start' policy. . . . [T]he debtor's fresh start comes at the expense of its creditors, who are forced to forgive a portion of the debt to which they would otherwise have been entitled.").

16. *Bankruptcy*, U.S. CTS., http://www.uscourts.gov/FederalCourts/Bankruptcy.aspx (last visited Oct. 11, 2015).

17. *Understanding Bankruptcy*, U.S. BANKR. CT. SOUTHERN DISTRICT W. VA., http://www.wvsb.uscourts.gov/understanding-bankruptcy (last visited Nov. 14, 2015).

1. Forms of Bankruptcy

a. Chapter 7

A bankruptcy under Chapter 7, or asset "liquidation," sometimes called a "straight" bankruptcy,[18] involves the appointment of a bankruptcy trustee who "gathers and sells the debtor's nonexempt assets and uses the proceeds" from these sales to pay off creditors.[19] The Code allows the debtor to keep certain property, such as "[r]easonably necessary clothing," "[r]easonably necessary household goods and furnishings," and "[a] portion of equity in the debtor's home," as exempt from being sold by the bankruptcy trustee.[20] Some of the debtor's property may not be available to the trustee because it is "subject to liens and mortgages that pledge the property to other creditors."[21] "If all the debtor's assets are exempt or subject to valid liens, the trustee will normally file a 'no asset' report . . . and there will be no distribution to unsecured creditors."[22]

Debtors applying for relief under Chapter 7 whose "current monthly income" exceeds their state's median income are subject to "a 'means test' to determine whether the Chapter 7 filing is presumptively abusive."[23] The "means test" operates as follows:

> Abuse is presumed if the debtor's aggregate current monthly income over 5 years, net of certain statutorily allowed expenses, is more than (i) $12,475, or (ii) 25% of the debtor's nonpriority unsecured debt, as long as that amount is at least $7,025. . . . The debtor may rebut a presumption of abuse only by a showing of special circumstances that justify additional expenses or adjustments of current monthly income. Unless the debtor overcomes the presumption of abuse, the case will generally be

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18. ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES, AND PROBLEMS 141 (6th ed. 2009).
19. *Chapter 7 - Bankruptcy Basics*, U.S. CTS., http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter7.aspx (last visited Nov. 14, 2015).
20. *Exempt vs. Non-exempt Property Under Chapter 7*, FINDLAW, http://bankruptcy.findlaw.com/chapter-7/exempt-vs-non-exempt-property-under-chapter-7.html (last visited Nov. 14, 2015).
21. *Chapter 7 – Bankruptcy Basics*, *supra* note 19.
22. *Id.*
23. *Id.*

converted to Chapter 13 (with the debtor's consent) or will be dismissed.[24]

Notably, Chapter 7 debtors "whose debts are mostly business-related" are exempted from this screening for abuse.[25]

b. Chapter 11

A Chapter 11 bankruptcy, or "reorganization," is more frequently used by corporations and partnerships, and usually involves the debtor "propos[ing] a plan of reorganization to keep its business alive and pay creditors over time."[26] Individuals may also be eligible for relief under Chapter 11.[27]

Applicants must generally file a disclosure statement with the court "contain[ing] information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the debtor's plan of reorganization."[28] Debtors also file a reorganization plan, which "must include a classification of claims and must specify how each class of claims will be treated under the plan."[29] If the court approves the disclosure statement, it "will [then] conduct a confirmation hearing to determine whether to confirm the plan."[30] In "small business case[s]," the court may determine that the disclosure statement is unnecessary if "adequate information is contained in the plan."[31]

In the case of individuals applying for relief under Chapter 11,[32] the plan "may be [funded] from the debtor's future earnings; and . . . cannot be confirmed over a creditor's objection without committing all of the debtor's disposable income over five years unless the plan pays the claim

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24. *Id.* (citing 11 U.S.C. § 707(b)(1) (2012)); *see also* WARREN & WESTBROOK, *supra* note 18, at 150 ("[T]he new Chapter 7 screen is semi-automated, employing a fixed formula to determine which debtors should be deemed ineligible.").

25. WARREN & WESTBROOK, *supra* note 18, at 150 (citing 11 U.S.C. § 707(b)(1)).

26. *Chapter 11 - Bankruptcy Basics*, U.S. CTS., http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter11.aspx (last visited Nov. 14, 2015).

27. *Id.*

28. *Id.*

29. *Id.* (citing 11 U.S.C. § 1123).

30. *Id.* (citing 11 U.S.C. § 1128).

31. *Id.* (citing 11 U.S.C. § 1125(f)).

32. The *Hawkins* case itself involved an individual filing for relief under Chapter 11, as did *Vaughn*. Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R 225, 227 (Bankr. N.D. Cal. 2010), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662 (9th Cir. 2014); Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 533 (Bankr. D. Colo. 2011), *aff'd*, No. 12-cv-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2013), *aff'd*, 765 F.3d 1174 (10th Cir. 2014).

in full, with interest, over a shorter period of time."[33] Unlike corporations, which "exist[] separate and apart from [their] owners, the stockholders," an individual doing business as a sole proprietorship will subject both personal and business assets to the bankruptcy process.[34] Partnership bankruptcies may also involve the use of individual partner's assets "to pay creditors . . . or the partners, themselves, may be forced to file for bankruptcy protection."[35]

c. Chapter 13

A Chapter 13 bankruptcy, known as an "individual debt adjustment," or "wage earner's plan," allows those who receive a regular income to "propose a repayment plan to make installments to creditors over three to five years."[36]

A principal advantage of proceeding under Chapter 13 is that it "offers individuals an opportunity to save their homes from foreclosure . . . and may cure delinquent mortgage payments over time."[37] Debtors may "reschedule secured debts (other than a mortgage for their primary residence) and extend them over the life of the [C]hapter 13 plan."[38] The length of the plan depends on the debtor's current monthly income.[39] If it is "less than the applicable state median, the plan will be for three years unless the court approves a longer period 'for cause.'"[40] If greater, "the plan generally must be for five years."[41]

"Any individual . . . is eligible for [C]hapter 13 relief as long as the individual's unsecured debts are less than $383,175 and secured debts are less than $1,149,525," amounts which "are adjusted periodically to reflect changes in the consumer price index."[42] Corporations and partnerships are not eligible for relief under Chapter 13.[43]

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33. *Chapter 11 – Bankruptcy Basics*, *supra* note 26 (citing 11 U.S.C. §§ 1115, 1123(a)(8), 1129(a)(15)).
34. *Id.* Stockholders of a corporation undergoing Chapter 11 bankruptcy do not risk their personal assets "other than the value of their investment in the company's stock." *Id.*
35. *Id.*
36. *Chapter 13 - Bankruptcy Basics*, U.S. CTS., http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter13.aspx (last visited Nov. 14, 2015).
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.* (citing 11 U.S.C. § 109(e) (2012)).
43. *Id.* (citing 11 U.S.C. § 109(e)).

2. Debts Nondischargeable Under Section 523(a)(1)(C)

Generally, due to the Code's underlying ethos of providing debtors with a "fresh start," with the exception of certain public policy exceptions, there is a presumption that all of a debtor's obligations will be discharged via bankruptcy.[44] Section 523 of the Code provides a statutory basis for such exceptions.[45] At issue in *Hawkins* was subsection (a)(1)(C), which provides that a debtor is not discharged from any debt "with respect to which the debtor made a fraudulent return or *willfully attempted in any manner to evade or defeat such tax*."[46]

In *United States v. Jacobs*, the Eleventh Circuit Court of Appeals spelled out what the government must prove in order for the exception to discharge under section 523(a)(1)(C) to apply: "523(a)(1)(C) 'contains a conduct requirement (that the debtor "attempted in any manner to evade or defeat [a] tax"), and a mental state requirement (that the attempt was done "willfully").'"[47] Satisfying the conduct requirement requires proof, "either through commission or culpable omission," that "the debtor engaged in affirmative acts to avoid payment or collection of the taxes."[48] Satisfying the mental state requirement of "willfulness" requires a "show[ing] that the debtor's attempt to avoid tax liability was 'done voluntarily, consciously or knowingly, and intentionally,'" which can be shown by proving: "(1) the debtor had a duty under the law, (2) the debtor knew he had that duty, and (3) the debtor voluntarily and intentionally violated that duty."[49] The burden of proving that both requirements for non-discharge of a particular debt have been met is borne by the government.[50]

44. "[E]xceptions to discharge should be limited to dishonest debtors seeking to abuse the bankruptcy system in order to evade the consequences of their misconduct." Hawkins v. Franchise Tax Bd., 769 F.3d 662, 666 (9th Cir. 2014) (quoting Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1016 (9th Cir. 2011), *abrogated by* Bullock v. Bankchampaign N.A., 133 S. Ct. 1754 (2013)); *see also* 11 U.S.C. § 727(b).

45. 11 U.S.C. § 523 (2012).

46. *Id.* § 523(a)(1)(C) (emphasis added).

47. United States v. Jacobs (*In re* Jacobs), 490 F.3d 913, 921 (11th Cir. 2007) (alteration in original) (quoting United States v. Fretz (*In re* Fretz), 244 F.3d 1323, 1327 (11th Cir. 2001)).

48. *Id.* (first citing *Fretz*, 244 F.3d at 1329–30; and then citing Gardner v. United States (*In re* Gardner), 360 F.3d 551, 558 (6th Cir. 2004)).

49. *Id.* (first quoting *Fretz*, 244 F.3d at 1330; and then quoting Griffith v. United States (*In re* Griffith), 206 F.3d 1389, 1396 (11th Cir. 2000)).

50. *Id.* (quoting *Griffith*, 206 F.3d at 1396).

B. Hawkins in Context

In order to understand the context in which the Ninth Circuit delivered its opinion in *Hawkins v. Franchise Tax Board*, it is necessary to provide a detailed background of the bankruptcy court's factual findings,[51] as determining whether a taxpayer's actions constitute a "willful evasion" involves a highly fact-sensitive analysis.

1. "Badges of Evasion"

At the outset of his opinion, Judge Thomas E. Carlson of the Bankruptcy Court for the Northern District of California made a point to emphasize that William "Trip" Hawkins was "a very sophisticated businessman," with an undergraduate degree from Harvard in Strategy and Applied Game Theory, and an M.B.A. from Stanford.[52] Hawkins's "exceptional business sophistication" was one factor that the court ultimately considered in determining that there was ample "evidence of willful failure to pay tax[es]" in this case.[53]

Other "badges of evasion" noted by the court included: "Trip's open acknowledgment of his tax debt and insolvency; the length of time over which Trip caused Debtors to expend funds on unnecessary expenditures after he acknowledged the tax debt; the amount of unnecessary expenditures; and the extent to which unnecessary expenditures exceeded Debtors' earned income."[54] These factors, taken together, were sufficient in the court's view to satisfy "both the conduct requirement and mental-state requirement" necessary to trigger the exception to discharge under section 523(a)(1)(C).[55]

"[A]n early employee of Apple Computer," eventually becoming the company's director of marketing, Hawkins left Apple in 1982 to "bec[ome] one of the founders of Electronic Arts, Inc. (EA), which became the largest supplier of computer entertainment software in the world."[56] His holdings of shares of EA stock were the significant driver of his net worth, which had reached approximately $100 million by 1996, the same year that he married Lisa Hawkins.[57] Lisa, a former leasing agent at a car dealership, stayed in the home following their marriage in order to

51. *See* Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 228–33 (Bankr. N.D. Cal. 2010), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662 (9th Cir. 2014).
52. *Id.* at 228.
53. *Id.* at 241.
54. *Id.* at 241–42.
55. *Id.* at 241.
56. *Id.* at 228.
57. *Id.*

"care[] for the two children she had with Trip and the two children Trip had from his first marriage."[58] The bankruptcy judge determined that Lisa was not guilty of "attempt[ing] in any manner to evade . . . tax,"[59] a decision which the district court affirmed.[60]

2. Beginnings of Financial Difficulty

After leaving EA to run 3DO, a wholly-owned subsidiary of EA, "[Hawkins] began to sell large amounts of his EA common stock to invest heavily in 3DO."[61] In 1996, the accounting firm KPMG advised him that these sales would realize "very large capital gains," and suggested that he utilize an investment vehicle to create capital losses, which could then be used to offset the gains.[62]

In turn, Hawkins invested in two transactions recommended by KPMG: one in 1996 called "FLIP" (Foreign Leveraged Investment Portfolio), and another in 1998 known as "OPIS" (Offshore Portfolio Investment Strategy).[63] FLIP worked as follows: an investor would "purchase" shares from the United Bank of Switzerland ("UBS"), along with "an option to acquire shares of Harbourtowne, Inc. (Harbourtowne), a Cayman Islands corporation"; simultaneously, Harbourtowne would contract to purchase shares of UBS treasury stock, with "UBS receiv[ing] an option to repurchase th[ese] shares before the sale closed."[64] In Mr. Hawkins's case, KPMG issued an opinion letter stating that he "could add to the tax basis of his UBS shares the $30 million Harbourtowne had contracted to pay for its . . . shares."[65] While not guaranteeing that the IRS would accept the validity of the transaction, the opinion letter suggested that such treatment for tax purposes would "more likely than

58. *Id.*

59. *Id.* at 234, 239–40.

60. Hawkins v. Franchise Tax Bd., 447 B.R. 291, 292 (N.D. Cal. 2011).

61. *In re Hawkins*, 430 B.R. at 228. 3DO was formed in 1990 and "went public [with its shares] in 1993." *Id.* Hawkins began selling "large amounts of his EA common stock" in 1994 in order to invest in the new venture. *Id.*

62. *Id.*

63. *Id.*

64. *Id.* This is a very basic description of the transactions. The mechanics of FLIP and OPIS are well beyond the scope of this Note. However, in light of the inherent deceitfulness of these "basis-shifting tax shelters" in the eyes of the IRS, *id.* at 229, and the court's awareness of Hawkins's "exceptional business sophistication," the nature of the transactions likely played a role in the lower courts' analysis and ultimate finding of willful tax evasion. *See supra* text accompanying notes 52–55.

65. *In re Hawkins*, 430 B.R. at 228.

not" be upheld.[66] OPIS operated in essentially the same manner as FLIP.[67]

As a result of his participation in FLIP and OPIS, Hawkins claimed losses on his tax returns from the years 1996 through 2000 in the following amounts, following "sales" of his UBS shares: 1996: $6,027,306; 1997: $23,396,798; 1998: $20,570,283; 1999: $3,566,297; 2000: $8,244,602.[68]

The IRS, through its issuance of Notice 2001-45 in July 2001, announced its opposition to "the validity of basis-shifting tax shelters, such as FLIP and OPIS[,] . . . reject[ing] the central concept upon which . . . [they] are based."[69] In the same month, the IRS began to audit Hawkins's 1997 tax return, focusing on the losses claimed from the FLIP transaction.[70] The audit was eventually expanded to encompass Hawkins's 1998–2000 returns as well.[71]

The following July, the IRS informed Hawkins that his "losses from the FLIP and OPIS transactions should be disallowed."[72] In March and July of 2005, Hawkins received assessments from the IRS and California Franchise Tax Board ("FTB") stating that he owed additional "taxes, penalties, and interest for tax years 1997–2000" in the amounts of $21 million and $15.3 million, respectively.[73]

Although the IRS offered a settlement program that would allow taxpayers who participated in such "basis-shifting tax shelters" to reduce their amount owed, and to possibly avoid certain penalties, the IRS denied Hawkins and his wife the opportunity to participate, as "one of the tax years in which [they] claimed FLIP losses was no longer open to audit."[74]

At the same time that Hawkins was experiencing tax problems, his investments in 3DO went sour as well.[75] "By late 2002, 3DO . . . was

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66. *Id.*
67. *Id.* at 229.
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.* Accordingly, Hawkins knew by July 2002 that his tax losses would be disallowed, and consequently, that he would owe a substantial amount of additional taxes for those years. *See id.* In July 2003, the IRS issued its "audit report, which disallowed the vast majority of the losses . . . [and] concluded [that] . . . the transaction lacked economic substance and business purpose apart from tax savings." *Id.* at 230. In October 2005, Trip and Lisa Hawkins were reportedly still spending "more than $1.0 million" annually on living expenses, despite an "annual after-tax earned income of [only] $150,000." *Id.* at 232.
73. *Id.* at 231.
74. *Id.* at 229–30.
75. *Id.* at 230.

experiencing severe financial difficulty . . . [and] needed a large infusion of capital . . . ."[76] Accordingly, Hawkins loaned the company approximately $12 million during the period "[b]etween October 2002 and January 2003."[77] Despite this infusion of capital, 3DO filed a petition for relief under Chapter 11 in May 2003, which was subsequently converted into a Chapter 7 liquidation in November 2003.[78]

Following this unfortunate change in his finances,[79] Hawkins sought to reduce the child support payments he owed to his first wife by filing a motion in family court in July 2003.[80] His motion was granted, but the judge required him to place some of his "assets in a trust that had been previously established for the support of [his] children," and placed a judicial lien on the trust's assets "to ensure that those assets could not be seized by taxing authorities."[81]

During these proceedings in family court, Hawkins's attorney acknowledged his client's tax debts, noting that the intention was to discharge the debts via bankruptcy proceedings.[82] His attorney also requested "that the order issued by the family court not include any reference to the planned bankruptcy petition" to avoid the appearance that the petition was being "filed in bad faith."[83]

3. Debtors' Lifestyle Before and After Acknowledging Tax Obligations and Insolvency

A major factor in the bankruptcy court's finding of willful tax evasion was its determination that the "[d]ebtors altered [their] lifestyle very little after it became apparent in late 2003 that they were insolvent."[84] In 1996, they purchased a $3.5 million home in Atherton, California, and "[i]n 2002, [they] purchased an ocean-view condominium in La Jolla, California for $2.6 million . . . [and] they continued to maintain both . . . [homes] until July 2006."[85] They also had a "private jet that they used for family vacations [and] business trips" that was purchased in 2000 for

76. *Id.*
77. *Id.*
78. *Id.*
79. *See id.* at 229–30.
80. *Id.* at 230.
81. *Id.* at 230–31.
82. *Id.* at 236–37.
83. *Id.* at 237.
84. *Id.* at 231–32, 241 (noting that the debtors "expend[ed] funds on unnecessary expenditures after . . . acknowled[ing] the tax debt").
85. *Id.* at 231–32.

$11.8 million, which they eventually sold in 2003.[86] In October 2004, "ten months after . . . acknowledg[ing] [their] tax liability and insolvency in the family court proceeding," the couple bought a fourth vehicle, "a $70,000 Cadillac SUV," despite being the only two drivers in the family.[87]

The bankruptcy court went on to note that the couple's "personal living expenses exceeded their earned income long after [Hawkins] had acknowledged that [they] were insolvent[,] . . . disclos[ing] annual after-tax earned income of $150,000 and annual living expenses of more than $1.0 million" in October 2005.[88] By the time they filed their petition for Chapter 11 relief on September 8, 2006, they had reduced their living expenses to $277,000 to go along with $272,000 of after-tax income, based on the information provided in the schedules filed in conjunction with their bankruptcy case.[89]

4. Debtors' Bankruptcy Under Chapter 11

The bankruptcy court found that Hawkins and his wife, in filing their petition for relief under Chapter 11 on September 8, 2006, did so "primarily for the purpose of dealing with their tax obligations."[90] Upon the sale of their Atherton home in July 2006, the Hawkinses realized net proceeds of $6.5 million, of which the entire amount was "paid to the IRS in partial satisfaction of its lien."[91] The following month, the FTB "seized $6 million from Debtors' various financial accounts," and shortly after filing their petition, the Hawkinses sold their condo in La Jolla, paying the entire $3.5 million in proceeds to the IRS.[92] Nonetheless, the couple still owed $19 million to the IRS and $10.4 million to the FTB after these sales and seizures.[93]

In accordance with their Chapter 11 petition, the Hawkinses proposed a reorganization plan providing for partial payment of the amounts owed to the IRS and FTB, which included proceeds from their participation in a successful class action suit against KPMG and "liquidation of the other assets of the estate."[94] The Chapter 11 reorganization resulted in a payment of approximately $3.4 million to the

86. *Id.*
87. *Id.* at 232, 238.
88. *Id.* at 232.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*
93. *Id.*
94. *Id.*

IRS, but little to FTB, "whose lien . . . w[as] junior to th[at] of the IRS," with the IRS contending that it was still owed $12 million afterwards.[95]

The Hawkinses then filed an action for declaratory relief on December 14, 2007, "seeking a determination that the [u]npaid [t]axes were in fact covered by the discharge entered by [the bankruptcy] court in October 2007," and the IRS and FTB responded in their answers that the unpaid taxes were within the purview of section 523(a)(1)(C), and thus "excepted from discharge."[96]

Based on the above findings, and applying the same legal standard later endorsed by the Tenth Circuit in *Vaughn*,[97] the bankruptcy court concluded that Hawkins was culpable for the willful evasion of taxes, and that his "income tax liabilities to the IRS and FTB for tax years 1997–2000 [were] excepted from discharge pursuant to section 523(a)(1)(C) of the Bankruptcy Code."[98]

C. Subsequent Proceedings

1. First Appeal: The United States District Court

Upon appeal, the United States District Court for the Northern District of California "review[ed the] bankruptcy court's findings of fact under the clearly erroneous standard and its conclusions of law de novo."[99] The standard of "clear error" asks "whether the reviewing court, based on all of the evidence, has a definite and firm conviction that a mistake has been made."[100] The reviewing court "views the evidence in the light most favorable to the party who prevailed below" and must uphold the trial court's decision "so long as the trial court's view of the evidence is plausible in light of the entire record."[101]

Applying this standard, the district court concluded that the bankruptcy court's characterization of Hawkins's living expenses as "truly exceptional" was not a clear error, as "numerous examples . . .

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95. *Id.*

96. *Id.* at 233.

97. *Id.* at 234; Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1181–83 (10th Cir. 2014).

98. *In re Hawkins*, 430 B.R. at 242. The bankruptcy court found no evidence provided by the government that established culpability on the part of Lisa Hawkins, and accordingly held that her liabilities were "not excepted from discharge." *Id.* at 241–42.

99. Hawkins v. Franchise Tax Bd., 447 B.R. 291, 293 (N.D. Cal. 2011) (citing FED. R. BANKR. P. 8013), *rev'd*, 769 F.3d 662 (9th Cir. 2014).

100. *Id.* (citing Anderson v. City of Bessemer City, 470 U.S. 564, 573 (1985)).

101. *Id.* at 293–94 (first citing Lozier v. Auto Owners Ins. Co., 951 F.2d 251, 253 (9th Cir. 1991); and then citing *Anderson*, 470 U.S. at 573–74).

supported the bankruptcy judge's finding that Hawkins had engaged in 'unnecessary' spending between 2004 and 2006."[102]

In reviewing the bankruptcy court's holding "that Hawkins willfully attempted to evade or defeat his taxes[, which] . . . addresse[d] a mixed question of law and fact," the district court applied a de novo standard of review.[103] After noting that the Ninth Circuit "ha[d] yet to articulate the standard to determine when a debtor has 'willfully attempted . . . to evade or defeat [a] tax,'" the court noted that other circuits, including the Eleventh, Sixth, and Second, had "interpret[ed] this provision to include both a 'mental state' prong (i.e., willfulness) and a 'conduct' prong (i.e., an attempt to evade or defeat tax)."[104]

The court then went on to reject Hawkins's contention "that Section 523(a)(1)(C) requires a showing of fraudulent intent or malice, [holding that] such a requirement is not supported by the plain language of the statute."[105] Rather, the court stressed that the exception from discharge under section 523(a)(1)(C) operates whether or not "the debtor made a fraudulent return *or* willfully attempted *in any manner* to evade or defeat such tax."[106]

The district court ultimately endorsed the test used by the bankruptcy court for "willfulness," first articulated by the Fifth Circuit in *Bruner*, and later applied by the Tenth Circuit in *Vaughn*.[107] The court determined that, as "Hawkins acknowledged his insolvency and considerable tax debt in papers filed in family court in January 2004 . . . [and] further acknowledged that he intended to discharge those taxes in bankruptcy," yet continued to spend excessively for over two years, he "satisfied the mental state requirement of Section 523(a)(1)(C)."[108]

The district court also determined that Hawkins had satisfied the conduct requirement, applying the standard articulated in *Jacobs* that the "requirement is satisfied where the government shows that '"the debtor engaged in affirmative acts to avoid payment or collection of the taxes, either" through commission or culpable omission.'"[109] While noting that "[m]ere nonpayment of a tax, without more, fails to satisfy the

102. *Id.* at 297.
103. *Id.* at 299–300 (citing Murray v. Bammer (*In re* Bammer), 131 F.3d 788, 792 (9th Cir. 1997) (en banc)).
104. *Id.* at 294.
105. *Id.* (citing United States v. Ron Pair Enters., Inc., 489 U.S. 235, 240–41 (1989)).
106. *Id.* at 294 (emphasis added) (quoting 11 U.S.C. § 523(a)(1)(c) (2012)).
107. *Id.* at 295; Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1181–83 (10th Cir. 2014); Bruner v. United States (*In re* Bruner), 55 F.3d 195, 197–99 (5th Cir. 1995); *see also* United States v. Jacobs (*In re* Jacobs), 490 F.3d 913, 921–25 (11th Cir. 2007).
108. *Hawkins*, 447 B.R. at 300.
109. *Id.* at 294 (quoting *In re Jacobs*, 490 F.3d at 921).

conduct requirement," the court stressed that "large discretionary expenditures, combined with nonpayment of a known tax, contributes to the conduct analysis."[110] Furthermore, in the court's view, "a *single* additional culpable act or omission" may satisfy the requirement when coupled with nonpayment.[111]

Assessing Hawkins's actions within this framework, the district court was satisfied with "[t]he bankruptcy court['s finding] that Hawkins 'willfully avoided the collection of tax by making unreasonable and unnecessary discretionary expenditures at a time when he knew he owed taxes and knew he would be unable to pay those taxes,'" thus sufficiently meeting the conduct requirement of section 523(a)(1)(C).[112]

2. Second Appeal: The Ninth Circuit Court of Appeals

"Absent circuit law on th[e] question," the Ninth Circuit seized the opportunity to articulate its own view of what is required to except a tax from discharge under section 523(a)(1)(C), ultimately deciding on a "specific intent standard."[113] While acknowledging that "[s]ome of our sister circuits have read 11 U.S.C. § 523(a)(1)(C) differently," the Ninth Circuit relied on "the structure of the statute as a whole," particularly the underlying policy of providing a "fresh start" to discharged debtors, to "argue[] for a stricter interpretation of 'willfully' than an expansive definition."[114] Accordingly, the Ninth Circuit remanded the case to be reanalyzed under the standard of "specific intent," which would require the government to "establish that [Hawkins] took the actions with the specific intent of evading taxes."[115]

Dissenting, Judge Rawlinson criticized the majority's "overly expansive interpretation of the 'fresh start' policy," and opined that "[t]he majority's conclusion . . . create[d] a circuit split and turn[ed] a blind eye to the shenanigans of the rich."[116] Judge Rawlinson also endorsed the

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110. *Id.* at 301–02 (first citing Griffith v. United States (*In re* Griffith), 206 F.3d 1389, 1394 (11th Cir. 2000); and then citing *Jacobs*, 490 F.3d at 926–27; Stamper v. United States (*In re* Gardner), 360 F.3d 551, 560–61 (6th Cir. 2004)).

111. *Id.* at 302 (emphasis added) (citing United States v. Fretz (*In re* Fretz), 244 F.3d 1323, 1329–30 (11th Cir. 2001); United States v. Fegeley (*In re* Fegeley), 118 F.3d 979, 984 (3d Cir. 1997); Toti v. United States (*In re* Toti), 24 F.3d 806, 809 (6th Cir. 1994)).

112. *Id.* at 296 (emphasis omitted) (quoting Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 234 (Bankr. N.D. Cal. 2010), *aff'd*, 447 B.R. 291, *rev'd*, 769 F.3d 662 (9th Cir. 2014)).

113. Hawkins v. Franchise Tax Bd., 769 F.3d 662, 669–70 (9th Cir. 2014).

114. *Id.* at 666–69.

115. *Id.* at 669.

116. *Id.* at 671 (Rawlinson, J., dissenting).

Tenth Circuit's treatment of the issue in *Vaughn*, a case which in his view "involv[ed] similar circumstances."[117]

II. HOW THE NINTH CIRCUIT'S "SPECIFIC INTENT" CONSTRUCTION OF "WILLFULNESS" CREATED A CIRCUIT SPLIT

With *Hawkins*, the Ninth Circuit was confronted with a case of first impression, as it had never been called upon to decide "what mental state is required in order to find that a bankruptcy debtor's federal tax liabilities should be excepted from discharge under 11 U.S.C. § 523(a)(1)(C)."[118] In deciding that "specific intent" was required for a finding that a taxpayer "willfully attempted in any manner to evade or defeat such tax," the court analogized section 523(a)(1)(C) to "similar provisions in the Internal Revenue Code," and looked to the underlying policy of the Bankruptcy Code to provide discharged debtors with a "fresh start."[119]

The Ninth Circuit decided *Hawkins* on September 15, 2014.[120] Just weeks earlier, the Tenth Circuit decided a case "involving similar circumstances," namely, "a wealthy taxpayer [seeking] to discharge through bankruptcy a substantial amount of taxes owed."[121] There, the court of appeals agreed with the bankruptcy court's determination "that § 523(a)(1)(C)'s mental state requirement is generally satisfied 'where the government shows the following three elements: 1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty,'" citing the *Hawkins* district court's opinion in the process.[122] Accordingly, the Ninth Circuit's opinion in *Hawkins* noted that "[s]ome of our sister circuits have read 11 U.S.C. § 523(a)(1)(C) differently," citing *Vaughn*, among others.[123]

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117. *Id.*

118. *Id.* at 663 (majority opinion).

119. *Id.* at 663, 666–67, 669; *see also* BLUM, *supra* note 15, at 99–100.

120. *Hawkins*, 769 F.3d at 662.

121. *Id.* at 671 (Rawlinson, J., dissenting); *see also* Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1178 (10th Cir. 2014).

122. *In re Vaughn*, 765 F.3d at 1181 (quoting Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 546 (Bankr. D. Colo. 2011) (citing United States v. Jacobs (*In re* Jacobs), 490 F.3d 913, 921 (11th Cir. 2007); Hawkins v. Franchise Tax Bd., 447 B.R. 291, 300 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662), *aff'd*, No. 12-cv-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2013), *aff'd*, 765 F.3d 1174).

123. *Hawkins*, 769 F.3d at 669 (citing *Vaughn*, 765 F.3d at 1181; United States v. Coney, 689 F.3d 365, 371 (5th Cir. 2012); Stamper v. United States (*In re* Gardner), 360 F.3d 551, 558 (6th Cir. 2004); United States v. Fretz (*In re* Fretz), 244 F.3d 1323, 1330 (11th Cir. 2001); United States v. Fegeley (*In re* Fegeley), 118 F.3d 979, 984 (3d Cir. 1997); *In re*

This portion of the Note will contrast the approach of the majority and dissent in *Hawkins* and then discuss the *Vaughn* case in greater detail in order to illustrate the divergence between the Ninth Circuit and its "sister circuits."[124]

A. *The Ninth Circuit's Reasoning*

1. "Willfulness" in the Context of the "Fresh Start"

With *Hawkins*, the Ninth Circuit was faced with the task of construing a provision, and the requisite mental state to satisfy the provision, for the first time, with the "key question" being "the meaning of the word 'willful' in the statute."[125] Noting that "willful . . . is a word of many meanings, its construction often being influenced by its context," the court proceeded to analyze its meaning in light of the Bankruptcy Code's aim of "provid[ing] a 'fresh start' to the discharged debtor."[126]

Accordingly, the court felt obliged to interpret an "exception[] to the broad presumption of discharge narrowly," as such "exceptions to discharge should be limited to dishonest debtors seeking to abuse the bankruptcy system in order to evade the consequences of their misconduct."[127]

2. The "Statute as a Whole"

Along with the "fresh start" policy, the Ninth Circuit also looked to "the structure of the statute as a whole" in deciding that a narrow, rather than expansive, interpretation of "willfully" was appropriate.[128] The court noted that section 523(a)(1) contains three categories which warrant exception from discharge: (A)—"debts [that] are excepted from discharge on a strict liability basis"; (B)—"tax debts for which a return was not filed or was filed late"; and (C)—"tax debts 'with respect to which the debtor

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Birkenstock, 87 F.3d 947, 952 (7th Cir. 1996); Dalton v. IRS, 77 F.3d 1297, 1300 (10th Cir. 1996)).

124. *See id.*

125. *Id.* at 666.

126. *Id.* (alteration in original) (first quoting Spies v. United States, 317 U.S. 492, 497 (1943); and then quoting United States v. Sotelo, 436 U.S. 268, 280 (1978)).

127. *Id.* (first citing Kawaauhau v. Geiger, 523 U.S. 57, 62 (1998); and then quoting Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1015–16 (9th Cir. 2011), *abrogated by* Bullock v. Bankchampaign N.A., 133 S. Ct. 1754 (2013)).

128. *Id.* (citing Children's Hosp. & Health Ctr. v. Belshe, 188 F.3d 1090, 1096 (9th Cir. 1999)).

made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.'"[129]

The Ninth Circuit viewed the placement of the fraudulent return offense together with attempted tax evasion in subsection (C) as indicating a requirement of "bad purpose" for "willful attempt[s] to evade taxation."[130] According to the court, if willful tax evasion "require[d] mere knowledge of the tax consequences of an act, and no bad purpose," it would not be logical for the offense to be placed with an offense which does require bad purpose, i.e., "the filing of a fraudulent return."[131]

3. Legislative History

Next, the court looked to the legislative history of section 523(a)(1), noting that the final version represented "a 'compromise' between the House and Senate versions of a bill," as "[t]he House version contained the 'willfully' language . . . while the Senate version instead excepted tax debts for which the debtor '*fraudulently* attempted to evade' the tax."[132] The court reasoned that it could not have been Congress's intention to "so drastically reduce[] [the meaning of the Senate's language] as to remove any bad purpose from the exception for attempted tax evasion," given that such a change was not mentioned in the congressional record.[133]

4. Analogizing to the Internal Revenue Code

After making note of case precedent that it took to support "[a] specific intent construction," the Ninth Circuit then sought to analogize section 523(a)(1)(C) to "almost identical" language in section 7201 of the Internal Revenue Code, which "makes it a felony to 'willfully attempt[] in any manner to evade or defeat any tax.'"[134]

The court noted that conviction under the Internal Revenue Code provision "requires the Government to prove that the law imposed a duty on the defendant, that the defendant knew of this duty, and that he voluntarily and intentionally violated that duty."[135] The court relied on

129. *Id.* at 667 (citing 11 U.S.C. § 523(a)(1)).
130. *Id.*
131. *Id.*
132. *Id.* (first citing H.R. REP. NO. 95-595, *as reprinted in* 1978 U.S.C.C.A.N. 5963; and then quoting S. REP. NO. 95-989 (1978), *as reprinted in* 1978 U.S.C.C.A.N. 5787).
133. *Id.*
134. *Id.* at 668 (alteration in original) (quoting I.R.C. § 7201 (2012)).
135. *Id.* (quoting United States v. Bishop, 291 F.3d 1100, 1106 (9th Cir. 2002)). This language parallels the approach used by the Tenth Circuit in *Vaughn* and preferred by the

the Supreme Court's "clarifi[cation]" of I.R.C. § 7201 in *Kawashima v. Holder*, which held "that such an attempt 'almost invariably' will 'involve[] deceit or fraud upon the Government, achieved by concealing a tax liability or misleading the Government as to the extent of the liability.'"[136] Thus, to interpret section 523(a)(1)(C) in a manner consistent with the Supreme Court's interpretation of I.R.C. § 7201, the court held that an exception to discharge of a debtor's tax liabilities "would require fraudulent, or at least specific, intent."[137]

5. The *Spies* Case

Finally, the Ninth Circuit turned to *Spies v. United States*, a Supreme Court case which distinguished "between the misdemeanor of willfully failing to pay a tax or file a timely return (§ 7203) with the felony of willfully attempting to evade or defeat a tax or its payment (present § 7201)."[138]

In *Spies*, the Court held that it "would expect willfulness in [a felony] case to include some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer."[139] Viewing the Court's task in *Spies* as "construing language almost identical to the phrase at issue [in *Hawkins*]," the Ninth Circuit concluded that "simply spending beyond one's income would not qualify as a 'willful[] attempt[] in any manner to evade or defeat such tax.'"[140]

6. The Ninth Circuit Majority's Conclusion

Based on the above analysis, the Ninth Circuit reached its conclusion that, in order for the exception to discharge under 11 U.S.C. § 523(a)(1)(C) to apply, "the government must establish that the debtor took the actions with the *specific intent* of evading taxes."[141] To hold

dissent in *Hawkins*. *See id.* at 671 (Rawlinson, J., dissenting); Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1181 (10th Cir. 2014).

136. *Hawkins*, 769 F.3d at 668 (alteration in original) (quoting Kawashima v. Holder, 132 S. Ct. 1166, 1175, 1177 (2012)).

137. *Id.*

138. *Id.* (citing Spies v. United States, 317 U.S. 492, 498 (1943)); *see also Spies*, 317 U.S. at 499 (noting that the difference between failure to pay a tax and willfully attempting to evade it is difficult to define).

139. *Spies*, 317 U.S. at 498.

140. *Hawkins*, 769 F.3d at 668 (alterations in original) (quoting 11 U.S.C. § 523(a)(1)(C) (2012)).

141. *Id.* at 669 (emphasis added).

otherwise, the court reasoned, would result in "few personal bankruptcies in which taxes would be dischargeable."[142]

After acknowledging that "neither the district court nor the bankruptcy court had the benefit of" the Ninth Circuit's conclusion on the matter, the court vacated the lower courts' judgments and remanded the case to be reanalyzed under the specific intent standard.[143]

B. The Dissent's Reasoning

1. An "Overly Expansive Interpretation" and a Circuit Split

Circuit Judge Rawlinson, writing in dissent, had "little doubt, if any, that William Hawkins deliberately decided to spend money extravagantly rather than pay his duly assessed state and federal taxes."[144] Rawlinson particularly took umbrage with the majority's "overly expansive interpretation of the 'fresh start' policy" of the Bankruptcy Code, finding that such an interpretation "could easily eclipse all discharge exceptions."[145] Furthermore, Rawlinson noted that "[t]he majority's conclusion . . . create[d] a circuit split and turn[ed] a blind eye to the shenanigans of the rich."[146]

2. The Bankruptcy Court's Findings

Rawlinson looked to the bankruptcy court's findings to paint a picture of what Hawkins knew and when he knew it.[147] Importantly, Rawlinson noted, "Hawkins was aware of the substantial sums he owed in taxes as early as 2004," when he acknowledged owing twenty-five million dollars in taxes "during family court proceedings to reduce child support payments."[148] "At the family court hearing, Hawkins'[s] bankruptcy attorney 'testified that Hawkins'[s] *intent was not to pay the tax debt*, but to discharge it in bankruptcy . . . .'"[149] After acknowledging this debt, Rawlinson's opinion stated, "Hawkins maintained a home worth well over \$3.5 million, and an ocean-view condominium worth well over \$2.6

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142. *Id.*
143. *Id.* at 670.
144. *Id.* (Rawlinson, J., dissenting).
145. *Id.* at 671.
146. *Id.*
147. *See id.* at 670.
148. *Id.*
149. *Id.* (alteration in original) (quoting Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 236 (Bankr. N.D. Cal. 2010), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662).

million."[150] Additionally, despite the fact that Hawkins and his wife were the only drivers in the family, "Hawkins purchased a fourth vehicle that cost $70,000."[151] During this period, it was determined that Hawkins's family "spent between $16,750 and $78,000 more" over their income each month.[152]

As the dissent noted, the bankruptcy court found the following "badges of evasion," upon which it based its opinion: "1) Hawkins'[s] 'exceptional business sophistication'; 2) his 'open acknowledgment of his tax debt and insolvency'; 3) the lengthy period of wasteful spending; 4) the amount of wasteful spending; and 5) 'the extent to which the wasteful expenditures exceeded . . . earned income.'"[153]

3. Analogizing to *Vaughn*

According to Rawlinson, these "badges of evasion" presented a situation remarkably similar to the situation the Tenth Circuit faced in *Vaughn*: "a wealthy taxpayer [seeking] to discharge through bankruptcy a substantial amount of taxes owed."[154] In *Vaughn*, "[t]he Tenth Circuit incorporated a number of findings from the bankruptcy court to support the conclusion that Vaughn acted willfully to evade taxes, including failure to preserve assets despite knowledge of substantial tax liability, and 'numerous large expenditures.'"[155]

Based on these observations, the Tenth Circuit was convinced that Vaughn satisfied all three elements of the mental state requirement: 1) he had a duty under the law; 2) he was aware that he had the duty; and 3) he "voluntarily and intentionally violated the duty."[156] Ultimately, Rawlinson advocated for the Ninth Circuit to follow suit in applying this

150. *Id.* (citing *In re Hawkins*, 430 B.R. at 231).
151. *Id.* (citing *In re Hawkins*, 430 B.R. at 232).
152. *Id.* (quoting *In re Hawkins*, 430 B.R. at 237).
153. *Id.* (alteration in original) (quoting *In re Hawkins*, 430 B.R. at 241–42).
154. *Id.* at 670–71 (citing Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1178 (10th Cir. 2014)).
155. *Id.* at 671 (quoting *In re Vaughn*, 765 F.3d at 1181 n.5); *In re Vaughn*, 765 F.3d at 1181 n.5 ("[Vaughn] made numerous large expenditures, including the 'purchase[] of a $1.7 million home . . . [the title of which was] in the sole name of . . . [his wife],' the creation and funding of 'a $1.5 million trust for his step-daughter' shortly before disclosing his participation in BLIPS to the IRS, and several purchases of jewelry and other luxury items." (alterations in original) (quoting Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 546 (Bankr. D. Colo. 2011), *aff'd*, No. 12-cv-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2013), *aff'd*, 765 F.3d 1174))).
156. *In re Vaughn*, 765 F.3d at 1181, 1183 (quoting *In re Vaughn*, 463 B.R. at 546) ("Ultimately, none of Appellant's arguments persuade us the bankruptcy court's determination that Appellant willfully attempted to evade his tax obligations is clearly erroneous.").

approach and concluded his dissenting opinion with the following quip: "Providing a fresh start under the Bankruptcy Code should not extend to aiding and abetting wealthy tax dodgers."[157]

C. *In re Vaughn*

1. Background

James Charles Vaughn, like William Hawkins, was a high-level executive renowned for his "business acumen."[158] After turning a "start-up venture into a multi-billion dollar company," he received $20 million in cash and $11 million in stock from the company who acquired the venture in a sale, triggering the need for "some kind of tax planning."[159]

Vaughn also received his tax advice from KPMG, who advised him to utilize "Bond Linked Issue Premium Structure" ("BLIPS"), a tax strategy similar to FLIP and OPIS which involves the participant making a "relatively small cash contribution," followed by "transactions" aimed at "ultimately facilitating a high tax loss for the participant without a corresponding economic loss."[160] As they did with Hawkins, KPMG advised Vaughn that BLIPS could lead to an IRS audit resulting in the assessment of additional taxes, a risk that Vaughn agreed to accept.[161] On his 1999 tax return, Vaughn reported $30.6 million in income from the sale, but as a result of his participation in BLIPS, he also reported a $32.3 million capital loss, as well as a $3.3 million ordinary loss.[162]

Vaughn was denied the opportunity to participate in the settlement program with the IRS "because he was unable to make full payment of his tax liabilities related to his participation in BLIPS."[163] As a result, he received notice in June 2004 of an $8.6 million deficiency owed to the IRS, and later of an additional "$120,000 for the year 2000 relating to the

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157. *Hawkins*, 769 F.3d at 671 (Rawlinson, J., dissenting).

158. *In re Vaughn*, 765 F.3d at 1175; *see supra* text accompanying notes 52–53.

159. *In re Vaughn*, 765 F.3d at 1175.

160. *Id.* at 1175–76; *see supra* notes 61–67 and accompanying text (discussing Hawkins's utilization of FLIP and OPIS and the basic mechanics of the transactions).

161. *In re Vaughn*, 765 F.3d at 1176.

162. *Id.* at 1176–77. "A net capital loss (capital losses exceeding capital gains) is subject to an annual deduction limit of $3,000 . . . . If a net capital loss exceeds $3,000, the excess must be carried over to the following year and is included in the computation of capital gains and losses of that year." *Capital Losses vs Ordinary Losses*, LOOPHOLELEWY.COM: SMALL BIZ TAXES, http://loopholelewy.com/loopholelewy/13-capital-gains-losses/capital-gains-losses-03-capital-losses-ordinary-losses.htm (last visited Nov. 14, 2015). Ordinary losses are not subject to the $3000 annual limitation. *Id.*

163. *In re Vaughn*, 765 F.3d at 1178.

carryforward of a disallowed investment-interest expense arising out of [his] BLIPS participation."[164]

Vaughn filed a Chapter 11 petition in November 2006, and then sought a declaration that his tax deficiencies were dischargeable in bankruptcy.[165] The bankruptcy court determined he "had both filed a fraudulent tax return and willfully evaded his taxes, which provided two independent grounds for finding his tax liability nondischargeable under 11 U.S.C. § 523(a)(1)(C)."[166] On appeal, the district court affirmed the bankruptcy court's order on willful tax evasion, but "declined to address the question of whether [Vaughn] filed a fraudulent tax return."[167]

Noting that the "clearly erroneous" standard of review applied, the Tenth Circuit ultimately concluded that "none of [Vaughn]'s arguments persuade[d] the[m]" that the bankruptcy court's finding of willful tax evasion was clearly erroneous.[168] In doing so, the Tenth Circuit thereby condoned the "willfulness" standard used by the bankruptcy court for determining whether Vaughn met "§ 523(a)(1)(C)'s mental state requirement," comprised of the following three elements: "1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty."[169]

The Tenth Circuit noted the bankruptcy court's determination that Vaughn "'exhibited behavior which was inconsistent with his business acumen' by 'participat[ing] in the BLIPS investment' and subsequently depleting his assets, 'knowing as he must have, the BLIPS investment constituted an improper abusive tax shelter with no economic basis and no reasonable expectation of profit.'"[170] In other words, Vaughn knew he "had a duty under the law," and "voluntarily and intentionally violated [that] duty."[171]

2. The "Split"

As noted above, the Ninth Circuit was not shy about reaching a different conclusion from its "sister circuits" as to section 523(a)(1)(C)'s

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164. *Id.* at 1179.
165. *Id.*
166. *Id.*
167. *Id.* (citing Vaughn v. IRS, No. 12-cv-00060-MSK, 2013 WL 1324377, at *2 (D. Colo. Mar. 29, 2013)).
168. *Id.* at 1180, 1183 (quoting Conoco, Inc. v. Styler (*In re* Peterson Distrib., Inc.), 82 F.3d 956, 959 (10th Cir. 1996)); *see supra* text accompanying notes 95–98.
169. *Id.* at 1181 (quoting Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 546 (Bankr. D. Colo. 2011), *aff'd*, 2013 WL 1324377, *aff'd*, 765 F.3d 1174).
170. *Id.* (alteration in original) (quoting *In re Vaughn*, 463 B.R. at 547).
171. *Id.* (quoting *In re Vaughn*, 463 B.R. at 546).

requisite mental state.[172] While one could make an argument that *Vaughn* is distinguishable from *Hawkins* on factual grounds,[173] the divergence in legal standards remains, as both the Ninth and Tenth Circuits were asked to answer the same question in these appeals: What is the appropriate *legal* standard to be applied in determining whether a taxpayer "*willfully* attempted in any manner to evade or defeat [a] tax?"[174]

By deviating from other circuits as to the appropriate standard to be applied when assessing "willfulness" under section 523(a)(1)(C), the Ninth Circuit has articulated an entirely new legal standard[175] that, given the relative degree of concurrence among the other circuits as to the applicable standard,[176] is particularly vulnerable to attack should the Supreme Court choose to grant certiorari in order to resolve the split.

As Part III of this Note will set forth in greater detail, the Court should grant certiorari and condone the standard applied by the Tenth Circuit and others, as that standard, while still requiring specific acts by the debtor to trigger the exception to discharge under section 523(a)(1)(C),[177] better protects the integrity of the bankruptcy system by making it harder for wealthy debtors to abuse its "fresh start" and escape accountability for their actions.[178]

III. WHY *HAWKINS* FAILS FROM A POLICY PERSPECTIVE AND HOW IT CAN BE REDRESSED

While the Ninth Circuit's opinion in *Hawkins* is not necessarily legally "unsound," it nonetheless creates a circuit split ripe for consideration by the Supreme Court and fails to further the underlying

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172. *See* Hawkins v. Franchise Tax Bd., 769 F.3d 662, 669–70 (9th Cir. 2014).

173. Within a month of learning that the IRS was investigating his participation in BLIPS, Vaughn "established an irrevocable trust for his step-daughter . . . [and] transferred $1.5 million . . . into the trust the day it was established." *In re Vaughn*, 765 F.3d at 1178. Mr. Vaughn's wife "was named as the trustee and secondary beneficiary." *Id.*

174. *Id.* at 1179 (emphasis added) (quoting 11 U.S.C. § 523(a)(1)(C) (2012)); *Hawkins*, 769 F.3d at 666; *see* 11 U.S.C. § 523(a)(1)(C).

175. *See Hawkins*, 769 F.3d at 669 ("[T]he government must [show] that the debtor took the actions with the specific intent of evading taxes.").

176. *See infra* note 213 and accompanying text.

177. *See* Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 234 (Bankr. N.D. Cal. 2010), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662 ("The necessary 'affirmative act,' or 'culpable omission' may consist of failure to file returns, concealment of income, fraudulent transfer or concealment of assets, or *unnecessary expenditures*." (emphasis added) (footnotes omitted)).

178. *See infra* notes 218 and accompanying text.

policy objectives of the bankruptcy process by allowing wealthy debtors to abuse the system.

In a case of first impression, the Ninth Circuit was free to decide upon the appropriate standard to be applied in courts within its jurisdiction when determining whether a taxpayer acted "willfully" in attempting to evade taxes.[179] However, by condoning a standard that conflicts with that used by other circuits,[180] the Ninth Circuit has presented the Supreme Court with an opportunity to clear up the conflict, and hopefully favor a standard which does not facilitate the type of abuse of the bankruptcy system that occurred in the *Hawkins* case. As Part III.A will illustrate, wealthy debtors already have no shortage of outlets with which to stretch the integrity of the bankruptcy system to its limits.

A. Exceptions, Exemptions, and Asset Protection

1. Exceptions to "the Broad Presumption of Discharge"

The Code is riddled with provisions that favor the rich. For example, while credit card debt, car loans, and gambling debt can be wiped out via bankruptcy, student loans cannot, regardless of whether or not the funds are disbursed by the government or a private institution.[181] Such an exception to the "broad presumption of discharge" underlying the "fresh start" policy represents a congressional policy determination, manifested in 2005's Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA," or the "2005 Amendments"),[182] that student loan debt is particularly susceptible to abuse of the bankruptcy system.[183] While debtors across the socioeconomic spectrum are likely to incur debts such as car loans and credit card debts, the wealthy are much less likely to be afflicted with crippling student loan debt.[184]

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179. *See Hawkins*, 769 F.3d at 670.

180. *See infra* notes 213 and accompanying text.

181. *See* 11 U.S.C. § 523(a)(8) (2012); Kayla Webley, *Why Can't You Discharge Student Loans in Bankruptcy?*, TIME (Feb. 9, 2012), http://business.time.com/2012/02/09/why-cant-you-discharge-student-loans-in-bankruptcy/.

182. Pub. L. No. 109-8, § 220, 119 Stat. 23 (2005).

183. "Some fear allowing graduates to discharge their private loans would create a situation where students take out many loans during college and then turn around and file for bankruptcy when they get their diploma." Webley, *supra* note 181. It is also worth noting that "[f]ederal and private student loan debt surpassed credit card debt for the first time in 2010 and [was] expected to hit $1 trillion [in 2012]." *Id.*

184. This disparity in student loan borrowing has also added to already staggering racial disparities in the attainment of wealth. *See* Nick Chiles, *African-Americans Lag in Accumulating Wealth Because of High Student Loan Debt and Lower Likelihood of Large Gifts and Inheritances*, ATLANTA BLACKSTAR (Feb. 20, 2015), http://atlantablackstar.com/

2. Protecting Retirement Plans

Another area where debtors with greater wealth are favored in bankruptcy is in the protection of retirement accounts from seizure by creditors. If a debtor's retirement plan is "ERISA-qualified,"[185] or if it qualifies as a "spendthrift" trust under applicable state law,[186] the account does not become part of the debtor's bankruptcy estate, the assets of which are used to pay off creditors.[187]

While protecting debtors' retirement accounts may seem to evince a noble intent on the part of Congress, the reality is that most debtors undergoing bankruptcy see no benefit from this protection.[188] For this protection to even be relevant to a debtor, they need to be fortunate enough to have money saved for retirement in the first place. This situation exposes "[a]n enduring irony of bankruptcy[:] . . . the most protection goes to those with the most things."[189]

3. Asset Protection Trusts

Along the same lines, debtors with property worth protecting have another means of doing so, at least in certain states: "self-settled" asset

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2015/02/20/african-americans-lag-in-accumulating-wealth-because-of-high-student-loan-debt-and-lower-likelihood-of-large-gifts-and-inheritances/.

185. *See, e.g.*, *In re* Orkin, 170 B.R. 751, 753 (Bankr. D. Mass. 1994) ("[E]mployee retirement benefits under ERISA-qualified pension plans are excluded from a debtor's bankruptcy estate."); *see generally* Employment Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified at title 29 of the United States Code).

186. A spendthrift trust is "[a]n arrangement whereby one person sets aside property for the benefit of another in which . . . the beneficiary . . . is unable to transfer his or her right to future payments of income or capital, and his or her creditors are unable to subject the beneficiary's interest to the payment of his or her debts." *Spendthrift Trust*, FREE DICTIONARY: LEGAL DICTIONARY, http://legal-dictionary.thefreedictionary.com/Spendthrift+Trust (last visited Nov. 15, 2015); *see also* 11 U.S.C. § 541(c)(2) (enforcing, for purposes of the Code, "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is *enforceable under applicable nonbankruptcy law*" (emphasis added)); WARREN & WESTBROOK, *supra* note 18, at 121 ("[D]ebtors are often able to keep retirement accounts out of their bankruptcy estates because such accounts are often set up as spendthrift trusts.").

187. *See* WARREN & WESTBROOK, *supra* note 18, at 121 ("If the account is ERISA-qualified, then federal law protects it from his creditors . . . . If it is not so qualified, the debtor can try again with state law.").

188. *See id.* at 125 ("Half of all Americans do not have a single dollar in a retirement account, and some of the specifically protected retirement and educational accounts are held by even fewer people.").

189. *Id.*

protection trusts. While not all states recognize the validity of such trusts, the trend has been toward greater recognition.[190]

Asset protection trusts operate as follows: a debtor establishes a trust, naming him or herself as both *trustee* and *beneficiary* of the trust.[191] The debtor then continues using the property of the trust as if it were their own; but, importantly, if a creditor obtains a judgment against the debtor and seeks to seize property which apparently belongs to the debtor, the debtor can successfully object to the seizure of property belonging to the trust, on the grounds that the property does not belong to the debtor, but rather to the trust.[192]

While such a scheme seems suspect at the very least, if not "actual[ly] inten[ded] to hinder, delay, or defraud" potential creditors,[193] "self-settled" trusts appear to enjoy the full protection of the Code, at least in states which recognize their validity, by virtue of the Code's "applicable nonbankruptcy law" language found in section 541(c)(2).[194] Accordingly, as long as a debtor does not establish such a trust with the explicit intent of avoiding a particular judgment, asset protection trusts provide wealthy debtors with another means for keeping valuable assets out of the bankruptcy estate, and thus out of the hands of creditors.[195]

4. Protecting the "Homestead"

Even more important than asset protection trusts and protection of retirement plans for many debtors is a state-provided "homestead exemption."[196] Homestead exemptions, which vary widely from state-to-

190. *See id.* at 213.

191. *See id.* at 212.

192. *See id.* at 212–13.

193. *See* 11 U.S.C. § 548(a)(1)(A) (2012).

194. *Id.* § 541(c)(2) ("A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title."); WARREN & WESTBROOK, *supra* note 18, at 214 ("If they are structured right, including a spendthrift provision and an automatic appointment of a third party as trustee if the trustee-debtor is sued, the debtor will claim that the property in such a trust is not property of the estate." (citing 11 U.S.C. § 541(c)(1))).

195. *See* WARREN & WESTBROOK, *supra* note 18, at 214 (describing such trusts as fraudulent only when "the debtor was clearly trying to avoid a particular claim").

196. Federal law, i.e., the Code, also provides for a homestead exemption, with the value currently capped at $22,975. 11 U.S.C. § 522(d)(1). The Code calls for a homestead exemption "not to exceed $15,000" in section 522(d)(1), but that figure is adjusted every three years "to reflect the change in the Consumer Price Index for All Urban Consumers " in section 104(a)(1). *Id.* § 104(a)(1). However, in order to take advantage of this provision, the debtor must live in a state that permits debtors to use the federal bankruptcy exemptions, rather than the state's own exemptions. *See* Baran Bulkat, *The Federal Bankruptcy*

state,[197] provide homeowners with a means of protecting a certain amount of equity in their home from seizure by creditors.[198]

From a policy perspective, particularly that of providing debtors with a "fresh start," providing an exemption to homeowners for a portion of their equity in a home makes sense, as it provides such debtors with capital to start anew following bankruptcy. However, in states that offer significantly high, or even unlimited,[199] amounts for the homestead exemption, we again see the "irony" of a bankruptcy system that offers the most protection to those with the most assets to lose.[200] For example, a debtor in Texas, which offers an unlimited homestead exemption, can potentially keep a multimillion dollar home and still file for relief under Chapter 7,[201] provided they otherwise satisfy the "means test" of section 707(b)(2).[202] Viewed in such light, large homestead exemptions look like another vehicle for wealthy debtors to enjoy the benefits of bankruptcy while avoiding its major pitfall: the seizure and subsequent sale of non-exempt assets to repay creditors.

Exemptions, NOLO: LAW FOR ALL, http://www.nolo.com/legal-encyclopedia/federal-bankruptcy-exemptions-property.html (last visited Nov. 15, 2015).

197. *See* WARREN & WESTBROOK, *supra* note 18, at 200. "Sixteen states protect less than $20,000 equity in a homestead." *Id.* Other states provide protection through the doctrine of "tenancy by the entirety"—preventing "creditor[s] of only one spouse from foreclosing on a homestead held by the entirety—that is, jointly owned by the married couple." *Id.* Meanwhile, states like Texas and Florida provide homeowners with an unlimited homestead exemption. *See id.* at 200–01.

198. *See id.* at 200 ("Typically, the homestead is exempt from execution by creditors up to a given dollar amount.").

199. *See id.* (noting states with unlimited homestead exemptions).

200. *See supra* text accompanying note 189.

201. *See* WARREN & WESTBROOK, *supra* note 18, at 201. As the authors suggest, this provides debtors with an incentive to engage in "exemption planning," or the shifting of assets from non-exempt to exempt property. *See id.*

202. *See* 11 U.S.C. § 707(b)(2) (2012). The "means test" is susceptible to manipulation by those with the knowledge of how to do so without the advice of a lawyer. *See* Cathy Moran, *What Your Bankruptcy Lawyer Can't Tell You*, MORAN LAW GROUP, http://www.bankruptcysoapbox.com/your-bankruptcy-lawyer-cant-tell/ (last visited Nov. 15, 2015). While "[l]awyers are not to advise incurring new debt," knowledgeable debtors can create new deductible expenses for the "means test" calculation by, for example, purchasing a new vehicle prior to filing for bankruptcy, as "vehicle ownership expense" is an allowable expense. *See id.* After the Supreme Court's decision in *Ransom*, debtors who have no outstanding payments remaining on their car are no longer eligible for an "ownership" deduction, thereby creating an incentive to purchase a new vehicle prior to filing. *See id.*; Ransom v. FIA Card Servs., N.A., 562 U.S. 61, 68 (2011) ("The plain language of the statute . . . 'does not allow a debtor to deduct an "ownership cost" . . . that the debtor does not have.'" (second alteration in original) (quoting Ransom v. MBNA, Am. Bank, N.A. (*In re* Ransom), 577 F.3d 1026, 1030 (9th Cir. 2009), *aff'd*, 562 U.S. 61)).

B. How Hawkins Facilitates Abuse of the Bankruptcy System

As Part III.A of this Note illustrates, there is a myriad of means available for debtors to protect assets—assuming they have assets to protect—from creditors in the bankruptcy process.[203] When Congress amended the Code in 2005 through the BAPCPA, one of the primary purported reasons for doing so was perceived "rampant" abuse of the consumer bankruptcy process.[204] In reality, however, what resulted was a bill that kept the same exemptions in place that favor debtors with assets worth protecting,[205] but which made it more difficult for middle- and working-class debtors, those likely to be in the direst of straits, to qualify for relief under Chapter 7 through the application of the formulaic, objective "means test."[206]

The Ninth Circuit's opinion in *Hawkins* continues this trend of paying lip service to the prevention of bankruptcy abuse,[207] while building and preserving a system that actually invites abuse by debtors of greater means—a system which facilitates the shielding of assets,[208] and places high barriers to challenging the abuses of such debtors

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203. *See supra* Part III.A.2–3.

204. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 221, 119 Stat. 23 (2005) ("Amendments to discourage abusive bankruptcy filings."); *Do We Need Another Bankruptcy Code Overhaul?*, ALLMAND LAW (Oct. 5, 2010), https://allmandlaw.com/bankruptcy/do-we-need-another-bankruptcy-code-overhaul ("The bankruptcy code overhaul was supposedly put in place to stop what some opponents of bankruptcy described as *rampant* abuse of the bankruptcy system." (emphasis added)).

205. *See, e.g.*, WARREN & WESTBROOK, *supra* note 18, at 207–08. "In the debates leading up to the 2005 Amendments," Senator Herb Kohl, a Democrat from Wisconsin, "proposed an amendment to cap permissible homestead exemptions at $250,000," at least with respect to discharges under federal bankruptcy law. *Id.* Though "[t]he amendment had widespread support, and . . . passed the Senate more than once," political pressure, particularly from "the Texas contingent," derailed inclusion of the cap in the final version of the amendments. *Id.* at 208.

206. "[U]nder the 2005 Amendments, the judges have their marching orders from Congress: Apply the formula to all Chapter 7 filers, then dismiss or convert the cases that the formula identifies as abusive." *Id.* at 151. "Even a debtor who passed the means test formula of 707(b)(2) could nonetheless be deemed an abuser by the court in section 707(b)(3)." *Id.*

207. *See* Hawkins v. Franchise Tax Bd., 769 F.3d 662, 666 (9th Cir. 2014) ("[E]xceptions to discharge should be limited to dishonest debtors seeking to abuse the bankruptcy system . . . ." (quoting Sherman v. SEC (*In re* Sherman), 658 F.3d 1009, 1015–16 (9th Cir. 2011), *abrogated by* Bullock v. Bankchampaign N.A., 133 S. Ct. 1754 (2013))).

208. *See supra* Part III.A.

through the application of exceedingly high standards, such as "actual"[209] or "specific"[210] intent.

1. The "Specific Intent" Standard Facilitates Abuse of the Bankruptcy System

While it is true that discharge is presumed following bankruptcy, Congress made it clear, through sections 523 and 727 of the Code,[211] that certain acts of the debtor could render some or all of the debtor's debts nondischargeable.[212] What Congress failed to make clear, however, was the level of culpability that would be necessary to trigger certain exceptions to discharge, hence the problem that we see in comparing *Hawkins* with similar cases from other circuits.

The Tenth Circuit, in *Vaughn,* as well as the Third, Fifth, Sixth, Seventh, and Eleventh Circuits, in their own respective cases, have reached the same conclusion as to what constitutes "willfulness" for the purposes of section 523(a)(1)(C).[213] In *Coney*, a 2012 case from the Fifth Circuit, the court noted that while it had not yet been called upon to provide its own construction of the statutory provision, other circuits

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209. *See* 11 U.S.C. § 548(a)(1)(A) (2012) (requiring "actual intent to hinder, delay, or defraud" in order for the trustee to "avoid any transfer . . . of an interest of the debtor in property, or any obligation . . . incurred by the debtor").

210. *See Hawkins*, 769 F.3d at 669 ("[T]he government must establish that the debtor took the actions with the *specific intent* of evading taxes." (emphasis added)).

211. *See* 11 U.S.C. §§ 523, 727.

212. *See id.* "The trustee or creditors may object to the debtor's discharge of particular debts under section 523 or of all debts under section 727." WARREN & WESTBROOK, *supra* note 18, at 229. The authors describe the operation of section 523 as a "rifle shot," while describing denial under section 727 as "global." *See id.* at 229–30.

213. *See* Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1181 (10th Cir. 2014) (quoting Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 546 (Bankr. D. Colo. 2011), *aff'd*, No. 12-cv-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2015), *aff'd*, 765 F.3d 1174); United States v. Coney, 689 F.3d 365, 374 (5th Cir. 2012) (citing Bruner v. United States (*In re* Bruner), 55 F.3d 195, 197 (5th Cir. 1995); United States v. Fretz (*In re* Fretz), 244 F.3d 1323, 1330 (11th Cir. 2001)); United States v. Jacobs (*In re* Jacobs), 490 F.3d 913, 921 (11th Cir. 2007) (quoting Griffith v. United States (*In re* Griffith), 206 F.3d 1389, 1396 (11th Cir. 2000)); Stamper v. United States (*In re* Gardner), 360 F.3d 551, 558 (6th Cir. 2004) (citing *In re Fretz*, 244 F.3d at 1330); *In re Fretz*, 244 F.3d at 1330; United States v. Fegeley (*In re* Fegeley), 118 F.3d 979, 984 (3d Cir. 1997) (quoting Semo v. IRS (*In re* Semo), 188 B.R. 359, 362 (Bankr. W.D. Pa. 1995)); *In re* Birkenstock, 87 F.3d 947, 952 (7th Cir. 1996) ("[T]he debtor must both (1) know that he has a tax duty under the law, and (2) voluntarily and intentionally attempt to violate that duty." (citing *In re Bruner*, 55 F.3d at 197)); *In re Bruner*, 55 F.3d at 197.

"*uniformly* . . . have declined to require that a debtor engage in such an attempt [to evade taxes] with the specific intent to defraud the IRS."[214]

By breaking from the ranks, the Ninth Circuit has made it easier for debtors like Hawkins, who know that they owe substantial taxes to the IRS, to continue living a "lavish lifestyle" while *consciously* intending to discharge such taxes through bankruptcy.[215] While they are not living extravagantly *because* they wish to evade their taxes, thus failing to satisfy the specific intent requirement,[216] they are living extravagantly while knowing that, by spending less, they would be better equipped to repay their tax obligations. Such a regime does not further one of the underlying purposes of the 2005 Amendments to the Code: curbing abuse of the consumer bankruptcy system.[217]

2. The Standard for "Willfulness" Adopted by the Tenth Circuit et al. Better Serves the Underlying Purpose of the Bankruptcy Code

A primary goal of bankruptcy law is to strike a balance between the debtor's "fresh start" upon discharge, and creditors' right to receive payment on valid obligations of the debtor.[218] The Ninth Circuit's decision in *Hawkins* fails to aid in striking this balance by forcing the government to prove an exceedingly high standard in order to except a debtor's tax obligations from discharge under section 523(a)(1)(C) of the Code.[219] By applying the standard used by the Tenth Circuit and others,[220] courts can

214. *Coney*, 689 F.3d at 371, 374 (emphasis added) (quoting *In re Fretz*, 244 F.3d at 1330).

215. *See* Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 237 (Bankr. N.D. Cal. 2010), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662 ("After [Hawkins] represented to the family court that he was liable for $25 million in federal and state taxes and that he was insolvent as a result, [the Hawkinses] spent between $16,750 and $78,000 more than their after-tax earned income each month.").

216. *Hawkins*, 769 F.3d at 670 ("[D]enial of discharge . . . requires that the acts be taken with the specific intent to evade the tax . . . .").

217. *See* H.R. REP. NO. 109-31(I), at 15 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 88, 101 ("S. 256 contains various reforms tailored to remedy certain types of fraud and abuse within the present bankruptcy system. . . . [The bill] addresses abusive practices by consumer debtors who, for example, knowingly load up with credit card purchases or recklessly obtain cash advances and then file for bankruptcy relief.").

218. *See* BLUM, *supra* note 15, at 100 ("The ideal point of equilibrium is to provide wide enough relief to maintain a safety net for unfortunate individual debtors and a means of salvaging viable business debtors, while at the same time protecting creditors from debtors who would use the law to evade payment of their debts or to shield dishonest or irresponsible conduct.").

219. *See Hawkins*, 769 F.3d at 671 (Rawlinson, J., dissenting) ("[The majority's] overly expansive interpretation of the 'fresh start' policy could easily eclipse all discharge exceptions.").

220. *See supra* note 213 and accompanying text.

more effectively "police" the bankruptcy process, and prevent debtors from abusing its "fresh start" policy.[221]

While Hawkins's acts might not rise to the same level of culpability as Vaughn's (Hawkins was lucky enough to have a trust protecting his assets set up by the court),[222] the facts nonetheless demonstrate an astute debtor[223] who saw an opportunity to flout a system that, for countless reasons,[224] remains a target for abuse, particularly by those with the sophistication and resources that are a prerequisite to manipulating such a complex system.[225] If the standard applied by the Tenth Circuit et al. were applicable to the Ninth Circuit as well, it could be clearly established that Hawkins had "a duty under the law" to pay his taxes, that he "knew he had that duty," and that, by living well beyond his means while knowing of this obligation and planning to discharge it in bankruptcy, he "voluntarily and intentionally violated that duty."[226]

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221. *See supra* note 218 and accompanying text.

222. *See* Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 230–31 (Bankr. N.D. Cal. 2010) ("The family court . . . required [Hawkins] to place additional assets in a trust that had been previously established for the support of the children [and] . . . imposed a judicial lien on all the assets . . . to [prevent them from] be[ing] seized by taxing authorities."). Vaughn, on the other hand, "established an irrevocable trust for his step-daughter" shortly after receiving advice from KPMG that he "voluntarily disclose his participation in BLIPS," placing "$1.5 million dollars into the trust the day it was established," and naming his wife "as the trustee and secondary beneficiary." Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1178 (10th Cir. 2014).

223. *See In re Hawkins*, 430 B.R. at 228 ("[Hawkins] is a very sophisticated businessman.").

224. While this Note makes reference to a number of features within the bankruptcy system that contribute to its overall shortcomings, the system's numerous flaws and Congress's failure to effectively craft a statute that fairly balances the rights of consumers and creditors are largely beyond the scope of this Note. However, as the underlying ethos of the Note is rooted in the disparity between how wealthy debtors are treated in the bankruptcy process relative to those of more modest means, its proposed solution to the situation presented by *Hawkins* must be viewed within the context of the broader goal: creating a bankruptcy system that is fundamentally fairer to the interests of all of its participants.

225. "The bankruptcy process is complex and relies on legal concepts like the 'automatic stay,' 'discharge,' 'exemptions,' and 'assume.'" *Process—Bankruptcy Basics*, *supra* note 14. See Moran, *supra* note 202, for an example of how the bankruptcy system can be "gamed" by those with the knowledge of how to engage in such "planning" without the aid of an attorney, as attorneys are barred from advising bankruptcy clients to take on new debts.

226. *See In re Hawkins*, 430 B.R. at 234 (quoting United States v. Jacobs (*In re* Jacobs), 490 F.3d 913, 921 (11th Cir. 2007)).

> The Government has met the required burden with respect to [William] Hawkins by establishing that for more than two and one-half years before filing for bankruptcy protection, he caused Debtors to make unnecessary expenditures in excess of Debtors' earned income, while he acknowledged that Debtors had a tax liability of $25 million, while he relied upon that tax liability in seeking a reduction

The "plain language" of section 523(a)(1)(C) is clear in contemplating a preclusion from discharge that covers more than just "fraudulent" acts of the debtor,[227] which are subject to the standard of "actual" or "specific" intent that is typically required to prove fraud.[228] The "in any manner" language of the statute expands the reach of subsection (C) beyond the realm of fraud,[229] allowing the judiciary to craft a standard that furthers the underlying policies of "the statute as a whole."[230] The Tenth Circuit and others have done so,[231] with the Ninth Circuit being the lone advocate of a "specific intent" construction of willfulness that is akin to that which is necessary to prove fraud.[232] By granting certiorari to hear this case, the Supreme Court can remedy the situation by creating a uniform standard to be applied to a federal law.

As this Note has advocated, the standard that the Supreme Court ultimately adopts should resemble that chosen by all other circuits which have decided the issue with the exception of the Ninth Circuit:[233] "1) the

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> of child support payments, while he knew Debtors were insolvent, while Debtors paid other creditors, and while Debtors planned to file bankruptcy to discharge their tax obligations.

Id. at 235 (footnote omitted).

227. *See* 11 U.S.C. § 523(a)(1)(C) (2012) (providing an exception to discharge where the "the debtor made a fraudulent return *or* willfully attempted *in any manner* to evade or defeat such tax" (emphasis added)); *see also* United States v. Coney, 689 F.3d 365, 371 (5th Cir. 2012) ("Section 523(a)(1)(C) creates two exceptions to discharge—when a debtor files a fraudulent return and when a debtor 'willfully attempt[s] in any manner to evade or defeat [a] tax.'" (alterations in original) (quoting 11 U.S.C. § 523(a)(1)(C))).

228. For purposes of section 548 of the Code, in order for a transfer or obligation to be deemed "fraudulent," it must be made "with *actual intent* to hinder, delay, or defraud." 11 U.S.C. § 548(a)(1)(A) (emphasis added). However, "fraud" can also be demonstrated where the debtor "received less than a reasonably equivalent value" in the transaction, provided one of four additional factors is present, such as the debtor being insolvent at the time of the transaction or at the time the obligation was incurred. *Id.* § 548(a)(1)(B)(i)–(ii).

229. *See id.* § 523(a)(1)(C).

230. *See* Hawkins v. Franchise Tax Bd., 769 F.3d 662, 666–67 (9th Cir. 2014) (looking to the "statute as a whole" in determining that "'willfully' is to be narrowly construed"). *But see* H.R. REP. NO. 109-31(I), at 1 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 88, 89 ("The purpose of the [BAPCPA] is to improve bankruptcy law and practice by restoring personal responsibility and integrity in the bankruptcy system and ensure that the system is fair for both debtors and creditors."). While the 2005 Amendments may come up short in reaching this stated goal, their underlying purpose is now reflected in "the statute as a whole," and should thus be considered in the analysis when attempting to discern the meaning of the term "willfully" for the purposes of section 523(a)(1)(C).

231. *See supra* note 213 and accompanying text.

232. *See Hawkins*, 769 F.3d at 667 ("[I]f a willful attempt requires bad purpose, then such acts are naturally grouped with other acts requiring bad purpose, such as filing a fraudulently false return.").

233. *See supra* note 213 and accompanying text.

debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty."[234]

CONCLUSION

While we will probably never see a perfect bankruptcy system, courts that are asked to construe its existing provisions can, and should, do so in a manner that reflects the underlying purpose of the Code. While a major ethos of the Code is to provide debtors with a discharge of their existing debts, and thus relief in the form of a "fresh start,"[235] a debtor's "fresh start" is not granted unequivocally, as sections 523 and 727 of the Code demonstrate.[236]

Abuse of the consumer bankruptcy process remains an ongoing issue, despite the Code's "major overhaul" via the 2005 Amendments. While a major focus of those Amendments centered on eligibility for Chapter 7, and consequently, the introduction of the "means test" under section 707(b)(2),[237] Congress failed to address the ease with which debtors of greater means can shield assets from the bankruptcy estate, or "convert" non-exempt assets into exempt assets.[238] The Ninth Circuit's decision in *Hawkins*, through its imposition of the specific intent standard on section 523(a)(1)(C), only bolsters this fundamental shortcoming of the Code by making it exceedingly difficult for the government to prove that a debtor *willfully* attempted to evade a tax.

Fortunately, of the handful of circuits that have been tasked with construing section 523(a)(1)(C)'s "mental state requirement," the Ninth Circuit has been the lone advocate of a specific intent construction of the requirement. All other circuits which have decided the issue have held that the "mental state requirement" is satisfied when: "1) the debtor had a duty under the law; 2) the debtor knew he had the duty; and 3) the debtor voluntarily and intentionally violated the duty."[239] The Supreme Court should therefore grant certiorari to hear *Hawkins*, and upon doing

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234. *See, e.g.*, Vaughn v. IRS (*In re* Vaughn), 765 F.3d 1174, 1181 (10th Cir. 2014) (quoting Vaughn v. IRS (*In re* Vaughn), 463 B.R. 531, 546 (Bankr. D. Colo. 2011), *aff'd*, No. 12-cv-00060-MSK, 2013 WL 1324377 (D. Colo. Mar. 29, 2013), *aff'd*, 765 F.3d 1174).

235. *See* BLUM, *supra* note 15, at 99–100.

236. *See* 11 U.S.C. §§ 523(a), 727 (2012).

237. *See id.* § 707(b)(2) (2012); H.R. REP. NO. 109-31(I), at 2 (2005), *as reprinted in* 2005 U.S.C.C.A.N. 88, 89 ("The heart of the bill's consumer bankruptcy reforms consists of the implementation of an income/expense screening mechanism ('needs-based bankruptcy relief' or 'means testing'), which is intended to ensure that debtors repay creditors the maximum they can afford.").

238. *See supra* Part III.A.2–4.

239. *In re Vaughn*, 765 F.3d at 1181 (quoting *In re Vaughn*, 463 B.R. at 546). *See supra* note 213 and accompanying text.

so, overturn the Ninth Circuit's decision and set forth that the standard for "willfulness" used by the Tenth Circuit and others shall be controlling with respect to section 523(a)(1)(C).

The standard advocated by the *Vaughn* court, while requiring a degree of "bad faith" on the part of the debtor,[240] leaves the court with sufficient flexibility to find that a debtor like Hawkins, who is aware of substantial tax obligations yet nonetheless continues to make "large expenditures,"[241] is attempting to abuse the bankruptcy process, and consequently, that his tax debts should be excepted from discharge under section 523(a)(1)(C) of the Code.

240. The third portion of the standard requires that the debtor take actions which "*voluntarily* and *intentionally* violate[]" their duty under the law. *In re Vaughn*, 765 F.3d at 1181 (emphasis added) (quoting *In re Vaughn*, 463 B.R. at 546).

241. *See* Hawkins v. Franchise Tax Bd. (*In re* Hawkins), 430 B.R. 225, 241 (Bankr. N.D. Cal. 2010) ("Hawkins willfully evaded payment of [his] tax debt . . . by causing Debtors to deplete their assets on large unnecessary expenditures for an extended period of time . . . while knowing that Debtors had a $25 million tax debt that they could not pay and did not intend to repay . . . ."), *aff'd*, 447 B.R. 291 (N.D. Cal. 2011), *rev'd*, 769 F.3d 662 (9th Cir. 2014).