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Alert

Appellate Court Holds FCC Penalty Claim Survives Chapter 11 Corporate Debtor's Discharge

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A Chapter 11 corporate debtor's monetary penalty obligation owed to the Federal Communications Commission ("FCC"), resulting from "fraud on consumers," survived the debtor's reorganization plan discharge, even when the FCC "was not a victim of the fraud," held the U.S. District Court for the Southern District of New York on Sept. 2, 2021. *In re Fusion Connect Inc.*, 2021 WL 3932346, *1 (S.D.N.Y. Sept. 2, 2021). On appeal, the court reversed the bankruptcy court's dismissal of the Government's non-dischargeability complaint, explaining that the fraud exception to dischargeability reaches debts owed to "creditors who were not themselves defrauded," such as the Government here. *Id.*, at *2. According to the court, the bankruptcy court had confirmed the debtor's reorganization plan with a broad discharge (i.e., release) of pre-bankruptcy debt, but the plan confirmation order put "stakeholders… on notice that [the FCC Penalty] could attach to the newly constituted [reorganized] entity," when its terms made the dischargeability of that liability "an open issue." *Id.*, at *12.

Relevance

The *Fusion* decision is important. A corporate debtor seeking chapter 11 reorganization relief ordinarily wants to clean up its balance sheet by eliminating unsecured liabilities with a discharge provision in a reorganization plan, permanently barring creditors from enforcing their pre-bankruptcy claims. When the bankruptcy court confirms the plan, the discharge will be a key part of the confirmation order. As the Third Circuit recently stressed in a similar context, "debtors [must] know their liabilities [in order to] implement a viable plan to obtain a fresh start." *Ellis v. Westinghouse Electric Co., LLC*, 2021 WL 3852612, *7 (3d Cir. Aug. 30, 2021). According to the Third Circuit, though, "the debtor's interest in a fresh start is not absolute, as the Bankruptcy Code tries to strike the 'delicate balance between the competing interests of creditors pursuing their claims and debtors in obtaining a fresh start and finality.'" *Id.*, at *4 (citation omitted).

Facts

The debtor's predecessor's ("B") had been engaged in defrauding consumers "for years." WL 3932346 at *1. As a result, B entered into a consent decree with the FCC in 2016, acknowledging its fraud, agreeing to issue refunds to consumers and to pay a "$4.2 million civil penalty to the United States ("FCC Penalty") in equal monthly installments over five years…. By its terms the consent decree bound [B's] successors, assigns, and transferees." *Id.* B later paid $1.2 million in refunds and credits to consumers and began paying the FCC Penalty. *Id.* *2. During 2018, however, Fusion, the debtor here, had merged with B's parent company, leaving "Fusion as the owner of [B's] business, and responsible for the outstanding FCC Penalty." *Id.*

Fusion filed a Chapter 11 petition in 2019 with "$2.1 million of the $4.2 million FCC Penalty" unpaid. The FCC filed a proof of claim for that amount and the bankruptcy court in late 2019 confirmed the Fusion reorganization plan. When confirming the plan, the bankruptcy court "stated that Fusion's continuing obligation for the outstanding civil penalty [to the FCC] 'shall depend upon a determination of whether those obligations are dischargeable'" — i.e., whether they would survive the reorganization plan. *Id.*

The Bankruptcy Court Litigation

The Government filed a non-dischargeability complaint in early 2020, alleging that the FCC Penalty was not dischargeable under Code §523(a)(2)(A), made applicable by Code §1141(d)(6). Although the Government conceded that the fraud exception to discharge in §523(a) applied only to bankruptcy cases "involving individual debtors…, Congress, by enacting the Abuse Prevention and Consumer Protection Act of 2005, in Code §1141(d)(6), had extended [the fraud exception to discharge] to corporate debtors in chapter 11 [cases]." *Id.*

The bankruptcy court granted Fusion's motion to dismiss the Government's complaint. It "agreed with Fusion that the exception to dischargeability for liabilities arising from fraud does not apply to the FCC Penalty because that exception does not reach debts owed to creditors who were not themselves defrauded. Because the victims of [B's] fraud consisted of consumers, and not the Government, [reasoned the bankruptcy court,] Section 523(a)(2)(A), and hence Section 1141(d)(6)(A), does not reach the FCC Penalty." *Id.* at *2.

Analysis on Appeal

The appellate court noted that the "Government's appeal presents a pure question of law: whether a civil penalty payable to the United States rising out of [a consumer fraud] constitutes a debt arising from [fraud], such that the penalty is exempted from discharge in bankruptcy under [Code] § 1141(d)(6)." *Id.* at *3.

Statutory Framework and Binding Precedent. A chapter 11 reorganization plan "discharges the debtor from any debt that arose before the date of such confirmation." Code § 1141(d)(1). "The discharge of such claims serves the bankruptcy policy of providing debtors with a 'fresh start' to permit their continued operation free of pre-bankruptcy debts." *DPWN Holdings (U.S.A.) Inc. v. United Airlines*, 747 F.3d 145, 150 (2d Cir. 2014).

Code § 523(a)(2)(A) "has… long prohibited debtors from discharging liabilities on account of their fraud, embodying a basic policy animating the Code of affording relief only to 'an honest but unfortunate debtor.'" *Cohen v. de La Cruz*, 523 U.S. 213, 217-18 (1998). This provision ordinarily applies in chapter 7 cases involving individual debtors. Congress thus intended to insure that "all debts arising out of fraud are excepted from discharge, no matter what their form." *Archer v. Warner*, 538 U.S. 314, 321 (2003).

The Supreme Court affirmed in *Cohen* that a chapter 7 debtor's actual fraud made his liability nondischargeable under § 523(a)(2)(A). It also held "that an award of 'treble damages assessed on account of the fraud'" was not dischargeable because it "fell within the scope of 'any debt' respecting 'money, property, services, or credit' that the debtor has fraudulently obtained." *Id.*, at *4, quoting *Cohen*, 523 U.S. at 218 and Code § 523(a)(2)(A). The Court stressed that because the "award of treble damages" in *Cohen* fell within the fraud exception to discharge, "the creditor ha[d] a corresponding 'right to payment'" of those damages. *Id.*, at *5, quoting *Cohen*, 523 U.S. at 218-19.

Section 1141(d)(6)(A). Congress "imported [in 2005] the relevant content of Code § 523(a)(2)(A) into chapter 11 [cases] via § 1141(d)(6)…." *Id.* "Section 1141(d)(6)(A) extends § 523(a)(2)(A) to [chapter 11 cases], by exempting from 'discharge a debtor that is a corporation from any debt… of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit." *Id.* at *5. By extending § 523(a)(A) to corporate debtors in chapter 11 cases, reasoned the court in *Fusion*, Congress was "presumed… to [have] adopt[ed]" the Supreme Court's interpretation in *Cohen*. *Id.* The district court therefore treated the *Cohen* analysis as "governing the issue presented" here. *Id.*, at *6.

FCC Penalty Nondischargeable Under Code 1141(d)(6)(A). The district court thus held that the "FCC Penalty fits within the § 523(a)(2)(A) exception to dischargeability, as analyzed in *Cohen*, and as extended to chapter 11 corporate debtors through 1141(d)(6)(A)." *Id.*, at *7. It first stressed the "breadth" of the Supreme Court's *Cohen* reasoning: "§ 523(a)(2)(A) bars the discharge of all liability arising from fraud." *Id.* (emphasis in text), quoting *Cohen*, 523 U.S. at 222. The district court also relied on other appellate decisions. *See*, e.g. *In re Pleasants*, 219 F.3d 372, 375 (4th Cir. 2000) (nondischargable debt "need not be owed, either in whole or part, to a victim of the fraud, or represent compensation" to the victim); *Hatfield v. Thompson*, 555 B.R. 1, 12 (10th Cir. BAP 2016) ("[T]here is no requirement that the debt be for something that the debtor obtains from the creditor.").

Rejection of Fusion Arguments. Rejecting Fusion's argument that the fraud in question "must have been directed at the creditor holding the debt," the district court relied on "decisions by the Eleventh and Third Circuits holding that § 523(a)(2)(A)'s requirement of a fraud consistent with the common-law elements of fraud is satisfied where the defrauded party or parties were person(s) other than the creditor in the bankruptcy [case]." 2021 WL 3932, 346, at *9. For example, the Securities and Exchange Commission ("SEC") had obtained a nondischargeable civil fraud judgment against the debtor because of his defrauding investors "[e]ven though the fraud had not been directed at the SEC." *Id.*, citing *In re Bilzerian*, 153 F.3d 1278, 1280 (11th Cir. 1998). And the Third Circuit held that the SEC's civil fraud judgments against the debtor were "nondischargeable because the evidence of fraud had been met as to [the debtor's] clients… even though the fraud had not been directed at the SEC." *In re Bocchino*, 194 F.3d 376, 382-83 (3d Cir. 2015).

The district court also rejected as "unusually unpersuasive" Fusion's argument that reversing the bankruptcy court "would saddle the stakeholders of the reorganized entity with the burden of [B's] wrongdoings that occurred even prior to Fusion's acquisition of the company." *Id.*, at *12. Not only did the "stakeholders knowingly" assume B's preexisting liability to the United States, but the bankruptcy court had also put them on notice that the FCC Penalty might survive any discharge that Fusion obtained in the plan confirmation order. "A stakeholder in the new company thus had their eyes open that [this] liability, like other continuing liabilities or business costs and risk, might live on." *Id.*

Policy Implications. More important, permitting Fusion "to shed a regulatory fraud penalty in this manner could invite mischief." *Id.* For example, it might encourage "the strategic offloading of such a liability onto a successor entity primed soon to file for reorganization under chapter 11," particularly when the entity "had a recent history of fraud." *Id.* "…[C]ourts have warned against interpreting the Code in a manner that would create perverse incentives for debtors that do not align with the Code's purposes." *Id.*, citing *In re Murphy*, 282 F.3d 828, 874 (5th Cir. 2002); *KeyBank Nat'l Ass'n v. Franklin Advisers Inc., Co.*, 600 B.R. 214, 231 (S.D.N.Y. 2019) (rejecting a "rule that would… create perverse incentives for the parties to engage in delay and gamesmanship in both the bankruptcy reorganization and the related litigation").

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Fusion may likely appeal to the Second Circuit. But the district court's thorough, carefully reasoned and sensible opinion will withstand the closest scrutiny. Chapter 11 should not be a haven for corporate debtors with a fraudulent past.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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