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Expert Analysis

False Claims Act Debts Held Non-Dischargeable in Bankruptcy

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In *United States ex rel. Minge v. Hawker Beechcraft*, 2014 U.S. Dist. LEXIS 42425 (S.D.N.Y. March 27, 2014), the U.S. District Court for the Southern District of New York revived a $2 billion suit brought against a Chapter 11 corporate debtor by two qui tam relators under the False Claims Act (FCA).[1] This decision is important because it may afford plaintiffs in FCA actions additional leverage against corporate debtors, regardless of the merits of their asserted FCA claims, and could, depending on the dollars at stake, impact the ability of a corporate debtor with potential FCA liability to successfully reorganize.

Hawker Beechcraft Case

In 2007, two former employees (plaintiffs) of TECT Aerospace, a subcontractor of Hawker Beechcraft Corporation (HBC), filed a qui tam action under the FCA against TECT and HBC in the U.S. District Court for the District of Kansas (the Kansas action). The plaintiffs alleged that the defendants knowingly made misrepresentations in their certifications to the government regarding components incorporated into aircraft sold to the government. The complaint sought more than $2 billion in damages sustained by the government, plus attorney fees and costs.

The Kansas action was stayed when HBC filed for bankruptcy in May 2012. In June 2012, HBC sent a notice to all of its creditors, including the plaintiffs, informing them of the commencement of the bankruptcy case. The notice, based on an official form generally used in Chapter 11 cases, provided that to avail themselves of the discharge exceptions in Section 1141(d)(6) of the Bankruptcy Code, creditors would be required to file a complaint in the bankruptcy case by a date certain, but the notice did not specify the date and instead stated that "notice of [the] deadline would be sent at a later date." No further notice was ever sent, however.

On Sept. 27, 2012, three months after the initial meeting of creditors, the plaintiffs sued HBC seeking a determination that their FCA claims were non-dischargeable. The plaintiffs asserted that, because they had pursued their qui tam claims on behalf of the United States and also stood to recover a portion of any damages awarded plus their attorney fees, their claims should be excepted from discharge under Section 1141(d)(6)(A) of the Bankruptcy Code.

Section 1141(d)(6)(A) provides that confirmation of a corporate debtor's plan of reorganization does not discharge it 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, or owed to a person as the result of an action filed under subchapter III of chapter 37 of title 31 or any similar State statute…."[2] Courts, including both the Bankruptcy and District Courts in the Hawker Beechcraft case, have held that Section 1141(d)(6)(A) addresses two independent categories of debt. The first clause (clause 1) excepts from discharge debt "of a kind" specified under Section 523(a)(2) that is owed to a domestic governmental unit. The second clause (clause 2) excepts from discharge debt that is owed to a person as the result of an action filed under the FCA.

HBC moved to dismiss the plaintiffs' suit on several grounds, including that the complaint was time barred because the plaintiffs had not complied with certain procedural requirements of Section 523(c) of the Bankruptcy Code (i.e., the action had not been commenced within 60 days of the initial meeting of creditors).

The plaintiffs responded that the 60-day deadline did not apply to their claims because Section 1141(d)(6)(A) only cross-references two specific types of debts listed in Section 523(a) and does not incorporate the procedural requirements of Section 523(c). Moreover, even if the procedural requirements were applicable, the deadline was never triggered because no notice of the specific deadline was ever provided to creditors. Thus, the plaintiffs requested that the court use its equitable powers to allow the complaint as timely filed.

The stakes were high for both sides. If the FCA claims were found to be dischargeable, then any judgment for the plaintiffs would be paid in "bankruptcy dollars" (i.e., their judgment would share with other creditors of HBC).[3] If the FCA claims were not dischargeable, however, then reorganized HBC would be on the hook for the entire amount of any judgment in favor of the plaintiffs.

Bankruptcy Court Decision

In a matter of first impression, the Bankruptcy Court dismissed the plaintiffs' FCA claims for the government's damages, holding that those claims were dischargeable.[4] It did not, however, dismiss the plaintiffs' "personal" claims for attorney fees and expenses, thus permitting the lawsuit to proceed with respect to those claims.

The Bankruptcy Court noted that there are two types of exceptions to discharge: "(1) those that are self-executing and (2) those that require the creditor to seek a determination of dischargeability in the bankruptcy court by a fixed deadline, failing which the exception does not apply and the debt is discharged."[5] If the exception is not self-executing, then a creditor must comply with the procedural requirements of Section 523(c) of the Bankruptcy Code by commencing an action to determine dischargeability within the 60 days after the first meeting of creditors in the case.

Here, the Bankruptcy Court held that even though it is not specifically referenced in Section 1141(d)(6)(A), Section 523(c) applied to clause 1 because it referenced Section 523(a). Thus, a creditor asserting an exception to discharge under clause 1 must timely seek such relief, which the plaintiffs did not do. To hold otherwise, the Bankruptcy Court reasoned, would limit the operation of Section 523(c) to cases

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involving individuals and would prejudice corporate debtors by potentially affording them a more limited discharge.

The District Court Appeal

The District Court granted the plaintiffs leave to file an interlocutory appeal, and then reversed and vacated the Bankruptcy Court's decision to the extent it held that the procedural requirements of Section 523(c) apply to clause 1 of Section 1141(d)(6)(A). The District Court held that the plain language of Section 1141(d)(6)(A) did not incorporate any procedural requirement for its exceptions to be effective, and that nothing in the language of that section indicated Congress' intent to import the procedural requirements of 523(c) to apply to a corporate debtor. Thus, on its face, all of Section 1141(d)(6)(A) is self-executing and FCA debts are non-dischargeable in any event.

Strategic Considerations

The District Court's decision is binding only in the Hawker Beechcraft case. As a result, other courts remain free to determine whether the exception to the discharge of FCA debts is self-executing or if qui tam relators must comply with the procedural requirements of Section 523(c). Nevertheless, corporate debtors should be concerned about this decision, which could be used by FCA plaintiffs to obtain a strategic advantage in negotiating settlements of their claims.

What Should Corporate Debtors Do? Given the uncertainty this decision creates, a prudent course of action for a corporate debtor may be to commence its own lawsuit in the bankruptcy case 61 days after the initial meeting of creditors asserting that the plaintiffs in the FCA action failed to comply with the procedural requirements of Section 523(c) (and that the FCA debt is dischargeable in any event).

If the court holds that the exception to the discharge of the FCA debt is not self-executing, then the FCA claims should be time- barred and dischargeable. If the court holds that the exception to the discharge is self-executing, and the FCA claims are not dischargeable, then that decision would at least provide the corporate debtor with a clearer picture of what it needs to do to propose a feasible plan of reorganization.[6]

What Should FCA Plaintiffs Do? In a somewhat ironic twist, despite the District Court's decision that the FCA plaintiffs were not subject to the procedural requirements of 523(c), plaintiffs should assume that those requirements do apply to them, and timely commence an action seeking a determination that their FCA claims are excepted from discharge (or, alternatively, seek an extension from the court of their time to file such a suit). There is no apparent downside for FCA plaintiffs in commencing the action; either the exception is self-executing and the FCA debt cannot be discharged, or, if the exception is not self-executing and the debt is subject to discharge, they must file the action to protect those claims in any event.

Asset Sales May Be an Alternative for Corporate Debtors Whose FCA Claims Are Not Dischargeable. If the FCA debt is held to be non-dischargeable, then a corporate debtor should consider whether it can sell its assets under Section 363 of the Bankruptcy Code. Generally, asset sales under the Bankruptcy Code permit debtors to sell assets free and clear of liens, claims and encumbrances. There may be, however, significant restrictions placed on the sale of certain asset classes typically associated with debtors who are subject to FCA claims (e.g., licenses to operate medical facilities). Before they file, corporate debtors should consider whether these sale restrictions will permit them to effectively reorganize under Chapter 11 should they be required to sell their assets.

> The Hawker Beechcraft case could be used by FCA plaintiffs to obtain a strategic advantage in negotiating settlements of their claims.

The Potential Effect of the District Court Decision on the Settlement of FCA Lawsuits. Should other courts agree that FCA debts are non-dischargeable, then the District Court's decision ultimately may have the effect of conferring significant negotiating power upon qui tam plaintiffs. As a result, debtors may be incentivized to settle qui tam actions early on—regardless of their underlying merits—to avoid potentially crippling judgments, and to eliminate possible obstacles to confirmation of a reorganization plan.

Specifically, in cases like *Hawker Beechcraft*, where the potential FCA liability is significant, debtors may not have sufficient resources to establish a reserve for plan distributions on account of any judgment in the FCA action, which a bankruptcy court might require in connection with plan confirmation. Litigating the FCA claims, however, could take significant time and resources, which, combined with the costs and other disadvantages of a protracted bankruptcy case, may be additional factors leading to (in some cases, imprudent) settlements.

The willingness of other parties in interest in the bankruptcy case, such as a creditors' committee, to go along with such a settlement will depend on their view of the underlying merits of the FCA complaint. If, for example, a committee doubts the validity of the FCA claims, it should be more likely to support the debtor in seeking to dismiss the non-dischargeability complaint and avoid the litigation expense, which would reduce the amount of cash available to distribute to creditors. On the other hand, if the committee thinks that the FCA complaint has merit, then its preference may be for the debtor to settle the FCA action in order to manage the impact on creditor distributions. A committee's view also may be informed by whether its constituency expects to continue to do business with the reorganized debtor and the impact an FCA claim could have on the reorganized debtor's survival.

The Hail Mary Pass for FCA Plaintiffs who Miss the Deadline. If the exception to the discharge of FCA debts is not self-executing, qui tam relators who miss the deadline to file a complaint are left with few options. One option might be to move to convert the Chapter 11 case to one under Chapter 7, which could reset the time in which the qui tam relator has to seek a determination of the dischargeability of its debt.[7] However, the likelihood of success on such a motion may be dubious absent other circumstances, such as a substantial or continuing loss to, or diminution of, the debtor's estate.

1. The False Claims Act includes a "qui tam" provision that allows individuals (called "relators") who are not affiliated with the government to file complaints on the government's behalf. Once the complaint is filed, the government has the option to intervene. If it declines to do so, the relator may proceed on behalf of the government. Generally, if the lawsuit is successful, the relator recovers a portion of any damages awarded to the government.

2. Sections 523(a)(2)(A) and (B) except from discharge certain claims for money or property obtained by the debtor by fraud or false pretenses. 11 U.S.C. §§523(a)(2)(A), (B). Thus, a corporate debtor's debt owed to a "domestic governmental unit" is not dischargeable in its bankruptcy case if the debt were obtained by, among other things, fraud. Subchapter III of chapter 37 of title 31 is titled "Claims Against the United States Government" and incudes the provisions of the FCA. 31 U.S.C. §§3729-3733.

3. The plaintiffs timely filed a proof of claim against HBC asserting claims of more than $2.2 billion.

4. Because HBC's plan of reorganization had been confirmed several months before the Bankruptcy Court rendered its decision, the dismissal had the effect of confirming the discharge of these claims.

5. *United States ex rel. Minge v. Hawker Beechcraft Corp.* (*In re Hawker Beechcraft, Inc.*), 493 B.R. 696, 701 (Bankr. S.D.N.Y. 2013).

6. Whether pending FCA claims are dischargeable may be determinative of whether or not a corporate debtor's plan is feasible. 11 U.S.C. §1129(d)(11) (plan confirmable only if it "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor."). However, under the District Court's decision, there is no requirement that a plaintiff seek a determination of the non-dischargeability of its debt prior to plan confirmation, if at all. For this reason, a bankruptcy court may consider informing parties early in the case that it will require such a determination for plan confirmation.

7. Fed. R. Bankr. P. 1019(2).

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