April 17, 2014

SELF-EXECUTING DISCHARGE EXCEPTION MAY SAVE $2.3 BILLION WHISTLEBLOWER SUIT AGAINST REORGANIZED DEBTOR

In a matter of first impression, the United States District Court for the Southern District of New York recently held that former employees of a subcontractor of Hawker Beechcraft Corporation ("Hawker")—a company that emerged from bankruptcy in 2013 and was purchased by Textron Inc. in early 2014—were not time-barred from invoking the discharge exceptions set forth in section 1141(d)(6)(A) of the Bankruptcy Code with respect to their whistleblowing claims against Hawker.[1] The court held that the Bankruptcy Code's discharge exception for corporate debts to governmental units arising from fraud are self-executing and do not require a creditor to affirmatively seek a ruling on the applicability of the exception before a specified deadline. The ruling clears the way for claimants to assert non-dischargeable claims late in the reorganization process—*or even after emergence*—and thus may add a degree of "uncertainty to . . . restructuring efforts" in future chapter 11 cases.[2]

Background

In July 2007, former employees of a Hawker manufacturer and subcontractor filed a *qui tam* suit[3] under the False Claims Act (the "FCA") alleging that Hawker and the subcontractor made misrepresentations in certifications to the government regarding certain components manufactured by the subcontractor and incorporated into military aircraft sold to the government.[4] The plaintiffs sought to recover more than $2.3 billion in damages, civil penalties and attorneys' fees and costs.

In May 2012, Hawker and certain of its affiliates filed for bankruptcy, thereby triggering application of the automatic stay with respect to the FCA suit. In September 2012, the plaintiffs commenced an adversary proceeding seeking a determination by the bankruptcy court that their FCA claims against Hawker were

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1 *United States ex rel. Minge & Kiehl* (*In re Hawker Beechcraft, Inc.*), Case No. 12-11873, Adv. No. 12-01890 (S.D.N.Y. Mar. 27, 2014) ("*Hawker Beechcraft*").

2 *Id.* at 23.

3 In a "*qui tam* suit" a private party brings an action on the government's behalf. The government, not the private party, is considered the real plaintiff; however, if the government succeeds, the private party receives a share of the reward.

4 *Minge* v. *TECT Corp.*, No. 07-1212-MLB (D. Kan.).

exempt from discharge under section 1141(d)(6)(A) of the Bankruptcy Code, which provides, in pertinent part, that:

> (6) [T]he confirmation of a plan does not discharge a debtor that is a corporation from any debt—
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> (A) of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a) that is owed to a domestic governmental unit ["Clause 1"], 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 ["Clause 2"] . . . .[5]

Hawker moved to dismiss the plaintiffs' adversary proceeding.

In August 2013, six month after confirmation of Hawker's plan of reorganization, the bankruptcy court granted Hawker's motion to dismiss with respect to the FCA claims for damages and penalties. In concluding that subparagraph (A) of section 1141(d)(6) consists of two independent clauses, the bankruptcy court found that (a) the plaintiffs had failed to commence their adversary proceeding before certain deadlines set forth in section 523(c)(1) of the Bankruptcy Code[6] and Rule 4007(c) of the Federal Rule of Bankruptcy Procedure[7] (the "Bankruptcy Rules"), which the court held were incorporated by reference into "Clause 1" and (b) those claims were owed to the government and, thus, not "debts owed to a person" within the meaning of "Clause 2".[8] The bankruptcy court permitted the adversary proceeding to survive with respect to plaintiffs' claims for attorneys' fees and expenses.[9] The plaintiffs sought, and received, permission to file an interlocutory appeal.

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5 Subchapter III of chapter 37 of title 31 governs claims against the United States Government and includes, among other things, claims under the FCA.

6 Section 523(c) provides, in pertinent part, that:

> [e]xcept as otherwise provided in [523(a)(3)(B)], the debtor shall be discharged from a debt of a kind specified [523(a)(2), (4) or (6)] unless, on the request of the creditor to whom such debt is owed, and after notice and a hearing, the court determines such debt to be excepted from discharge under [section 523(a)(2), (4) or (6)] as the case may be.

7 Bankruptcy Rule 4007(c) provides that "a complaint to determine the dischargeability of a debt under 523(c) shall be filed no later than 60 days after the first day set for the meeting of creditors under [11 U.S.C.] § 341(a)" unless the court extends the deadline for cause. The plaintiffs commenced their adversary proceeding on September 27, 2012—more than 60 days after the section 341 meeting—which took place on June 26, 2012. Although the official form of notice of such meeting stated that notice of the deadline to seek a determination of dischargeability would be sent to creditors "at a later time," the bankruptcy court found this "irrelevant" on the grounds that Bankruptcy Rule 4007(c) expressly establishes a 60 day deadline to initiate such adversary proceedings. *Hawker Beechcraft* at 8.

8 Under section 101(41) of the Bankruptcy Code, governmental units are excluded from the definition of a "person."

9 The bankruptcy court did not rule on whether, or the extent to which, the plaintiffs had personal claims against Hawker and, therefore, allowed such claims to survive.

Analysis

Based on the "plain text" of section 1141(d)(6)(A), the district court concluded that the bankruptcy court erred in finding that the plaintiffs' claims did not qualify for the section 1141(d)(6)(A) discharge exception as a matter of law. Accordingly, the court reversed and vacated those portions of the bankruptcy court's opinion with respect to such findings and remanded the adversary proceeding to the bankruptcy court for further proceedings.[10]

First, the court stated that "[w]here the statute's language is plain, the sole function of the courts is to enforce it according to its terms."[11] In evaluating the plain language of the statute, the court agreed with the bankruptcy court's conclusion that section 1141(d)(6)(A) consists of "two separate and independent clauses": (i) "Clause 1," which exempts from discharge any debt of a kind specified in paragraph 2(A) or 2(B) of section 523 of the Bankruptcy Code[12] and (ii) "Clause 2," which exempts any debt owed to a person as a result of an action filed under specified statutes, including the FCA.[13]

Second, the court addressed the bankruptcy court's finding that "Clause 1" of section 1141(d)(6)(A) incorporates by reference the procedural requirements set forth in section 523(c)(1) and Bankruptcy Rule 4007(c), which require creditors to commence an adversary proceeding within a proscribed time period to except their claims from discharge. The court disagreed. Again looking to the "plain language" of the statute, the court observed that section 1141(d)(6)(A) neither sets forth nor incorporates *any* procedural requirement for the application of its discharge exceptions. The court concluded that, "[o]n its face," "Clause 1" is self-executing.[14]

The court acknowledged that "Clause 1" refers to debts of a "kind" included in section 523, but noted that section 523 applies to individual debtors, whereas section 1141(d)(6) applies only to corporate debtors. The court characterized the use of the word "kind" as describing two types of debts encompassed by

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[10] *Hawker Beechcraft*. at 3, 27.

[11] *Id*. at 10.

[12] The court noted that only paragraph 2(A) of section 523 is relevant to this case because it describes a debt "for money, property, services, or an extension, renewal, or refinancing of credit, to the extent obtained by—(A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition . . . ." *Id*. at 2.

[13] *Id*. at 10. As support for this view, the court noted that subdivision (A) consists of two clauses separated by a comma and joined by an "or" and, furthermore, that "Congress's parallel use of the phrase 'owed to' . . . means that the only reasonable reading is to create two separate clauses." *Id*. at 11 (citing H.R. Rep. No. 109-31 at 102 (2005) ("Section 708 amends 1141(d) of the Bankruptcy Code to except from discharge in a corporate chapter 11 case a debt specified in subsections 523(a)(2)(A) or (B) of the Bankruptcy Code owed to a domestic government unit. ***In addition,*** it exempts from discharge a debt owed to a person as a result of an action filed under subsection III of chapter 37 of title 31 of the United States Code or any similar statute.") (emphasis supplied).

[14] *Hawker Beechcraft* at 12.

section 1141(d)(6) – nothing more.[15] Accordingly, the court held that there are no procedural requirements for the exceptions to discharge set forth in section 1141(d)(6)(A) to take effect and, therefore, that plaintiffs' claims were not time-barred.

The court acknowledged that asserting a "significant non-dischargeable claim late in the reorganization process, even after a plan is confirmed, could render uncertainty to any [future] restructuring efforts."[16] Nevertheless, as the court stated, "the statute is as it is written."[17]

Having found that the plaintiffs' claims may qualify for the "Clause 1" discharge exception, the court declined to reach the issue of whether their claims also qualify as "debts owed to a person" under "Clause 2" of section 1141(d)(6)(A).

Finally, the court addressed certain other issues raised by Hawker regarding the applicability of section 1141(d)(6)(A), which the bankruptcy court declined to reach in light of its conclusion that the plaintiffs' claims were time-barred. Specifically, the court found that the plaintiffs have standing to file the adversary complaint and prosecute the FCA claims, even though the injury complained of is an injury to the United States.[18]

Conclusion

Hawker Beechcraft highlights that reorganized debtors may have exposure for prepetition corporate debts to governmental units arising from fraud, including, but not limited to, whistleblowing claims under the FCA or fraud claims relating to any government-sponsored loan program, government contract or Medicare/Medicaid. The decision may lead debtors to affirmatively seek a ruling on the dischargeability of questionable fraud claims before emerging from bankruptcy (rather than relying on creditor inaction). Buyers seeking to purchase debtors with such liabilities should be mindful of *Hawker Beechcraft* when structuring their transactions; purchasers may wish to acquire a company's assets through a sale under section 363 of the Bankruptcy Code and condition the sale on a ruling that the assets are being sold "free and clear" of such liabilities.

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15 *Id.* at 13. The bankruptcy court also noted that such interpretation is consistent with prior case law and comports with section 1141(d)(2), which expressly provides that such subsection applies to individuals, thereby indicating that "when the legislature uses certain language in one part of the statute and different language in another, the court assumes different meanings were intended." *Id.* at 15 (citing *Sosa* v. *Alvarez-Machain*, 542 U.S. 692, 711 n.9 (2004)).

16 *Hawker Beechcraft* at 23.

17 *Id.*

18 *See id.* at 24 (citing *Vermont Agency of Nat'l Resources* v. *U.S. ex rel. Stevens*, 529 U.S. 765 (2000).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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