Are Certain Obligations of Corporate Debtors Not Dischargeable in Subchapter V Small Business Bankruptcy Cases?

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Introduction

Congress passed The Small Business Reorganization Act ("SBRA") in 2019, effective in February 2020. The SBRA added subchapter V to chapter 11 of the Bankruptcy Code, the purpose of which is to assist small businesses and individual debtors with business-related debts to reorganize without the more significant costs and legal restraints of a traditional chapter 11 bankruptcy.

Among other provisions, the SBRA added §1192 of the Bankruptcy Code, which governs the discharge of debts in a confirmed subchapter V plan. Section 1192 provides that a court shall grant the debtor a discharge of its obligations, except for any debt "of the kind specified in §523(a) of this title." 11 U.S.C. §1192. The statute does not distinguish between individual or corporate debtors, but references debtors generally.

In turn, Bankruptcy Code §523(a) has 19 subsections, each identifying a kind of debt that is not dischargeable. 11 U.S.C. §523(a). Specifically, §523(a) states at the outset that "[a] discharge under §727, 1141, *1192*, 1228(b), or 1328(b) of this title does not discharge an *individual debtor* from any debt …,"

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KEY POINTS

1. The Fourth Circuit has applied the list of debts excepted from discharge to corporate debtors in subchapter V cases.
2. Every bankruptcy court that has ruled on the issue has declined to expand the non-dischargeable debts to corporate small business debtors.
3. Subchapter V will be much less attractive if the scope of nondischargeable debts is expanded to corporate small business debtors.

and then lists 19 categories of debt. *Id.* (emphasis added).

Several cases have considered the relationship between §§1192 and 523(a); specifically, whether the §523(a) exceptions to discharge apply to debts of *both* individual and corporate debtors. In other words, are the kinds of debts identified in §523(a) as non-dischargeable, with respect to an "individual" debtor, also not subject to discharge in a corporate subchapter V case because for purposes of §1192 they are "of the kind" described in the former statute?

Analysis of Reported Decisions

As of this writing, every bankruptcy court that has decided the question, together with the Ninth Circuit BAP, have answered in the negative. The Fourth Circuit Court of Appeals, however, the only circuit court to address the issue, disagreed, holding that the debts not subject to discharge under §523(a) apply to both individual and corporate debtors in subchapter V cases.

The first bankruptcy court decision on the matter was *Gaske v. Satellite Restaurants Inc.* (*In re Satellite Restaurants Inc.*), 626 B.R. 871 (Bankr. D. Md. 2021). The plaintiffs sought a determination that the debts owed to them by the corporate debtor were non-dischargeable under §523(a). The debtor moved to dismiss, arguing that §523(a) did not apply because it was not an individual.

The court's analysis began with the plain language of §523(a), which it said clearly and unambiguously applies only to individual debtors. Next, the court noted the rule of statutory interpretation that "every word must be given meaning so that no word is rendered superfluous." When Congress added subchapter V to chapter 11, it amended §523(a) to include a specific reference to §1192. If that reference is to have meaning, the court explained, a discharge under §1192 must only apply to individuals, for if Congress meant for the §523(a) exceptions to apply to corporate debtors it would not be necessary to reference §1192 in a statute expressly applicable only to individual debtors. The court also examined the legislative history of §1192 and found nothing suggesting Congressional intent to expand §532(a) to non-individuals.

Shortly after the *Gaske* decision, the same issue came before the bankruptcy court in *Catt v. Rtech Fabrications LLC* (*In re Rtech Fabrications LLC*), 635 B.R. 559 (Bankr. D. Idaho 2021). Referencing *Gaske*, the court in *Catt* similarly noted that every word in a statute must be given effect and by its terms §523(a) applies only to individuals. The court also observed that if Congress wanted to make clear that it was referencing the *types of debts* in §523(a), and not the *types of debtors*, it could have made the reference in §1192(2) more specific by, for example, drafting it to say "except any debt of the kind specified in §523(a)(1)-(19)." As written, the court noted, the cross-reference in §1192(2) to §523(a) includes the preamble language that limits its applicability to individual debtors.

The bankruptcy court in *Cantwell-Cleary Co. v. Cleary Packaging LLC* (*In re Cleary Packaging LLC*), 630 B.R. 466 (Bankr. D. MD 2021), *rev'd* 36 F.4th 509 (4th Cir. 2022), agreed with these early conclusions, ruling that §523(a)'s non-discharge provisions only applied to individual debtors. The court relied on the introductory language of §523(a) limiting the statute to individual debtors, as well as the history of bankruptcy law and bankruptcy courts protecting a corporate debtor's discharge.

Like the court in *Gaske*, the bankruptcy court in *Cleary* referenced the legislative history of §523(a) and the need to interpret subchapter V consistent with the rest of chapter 11. This history was critical to the court's analysis. Since the enactment of the Bankruptcy Code, the only categorical exceptions to a corporate debtor's discharge are contained in §1141(d)(6), and that provision "required approximately eight years to become law." Against this backdrop, the court found it improbable that Congress suddenly created 19 additional exceptions to discharge for corporations in a bill that was signed into law only months after it was introduced.

But the Fourth Circuit was less skeptical on appeal; in the only circuit court opinion to address the issue, it overruled the bankruptcy court's decision and is presently the only court to decide that the debts identified in §523(a) are nondischargeable as to both individual and corporate debtors in subchapter V.

Like the bankruptcy courts before it, the Fourth Circuit began its analysis with the text of §1192(2), which excepts from discharge "any debt…of the kind specified in §523(a)." 11 U.S.C. §1192. The court found that the combination of the words "debt" and "of the kind" indicate that Congress intended to reference the kinds of debt listed in §523(a), without regard to a specific kind of debtor.

The appellate court added that, to the extent there is tension between §§523(a) and 1192(2), the more specific provision should govern, citing this as a rule of statutory interpretation. Because §1192(2) specifically governs dischargeability of debts in subchapter V, the language of that provision should govern. Section 1192(2) itself does not distinguish between corporate and individual debtors, so the court concluded that the provision applies to both.

Next, the Fourth Circuit in *Cleary* noted that in other parts of the Bankruptcy Code, Congress distinguished the kinds of debtor covered by each provision. Because §1192(2) refers to debtors


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generally, the court concluded that it must apply to both corporate and individual debtors. The court believed that a different interpretation would create difficulty reconciling §523(a) with §1141(d)(6), which identifies the rare debts not subject to discharge by a corporate debtor. Section 523(a) includes all of §1141 in its scope in the same manner that it includes §1192 and §1141 as applying to *both* corporate debtors and individuals. The court queried why the limiting language in the preamble of §523(a) should apply to §1192 but not §1141.

Finally, the Fourth Circuit believed that its interpretation made sense considering the distinct purpose of subchapter V within chapter 11. In the court's view, §1192 was meant to "provide benefits to small business debtors, whether they are individuals or corporations." An interpretation in which dischargeability exceptions only applied to individual debtors would frustrate this purpose. The court also found that because subchapter V applies to corporate and individual debtors alike, distinguishing between individual and corporate debtors in the context of §523(a) exemptions would violate principles of fairness and equity.

Bankruptcy courts outside the Fourth Circuit have not followed its lead. The decision in *Avion Funding v. GFS Industries LLC* (*In re GFS Industries LLC*), 647 B.R. 337 (Bankr. W.D. Tex. 2022), was decided in the wake of the *Cleary* decision and sets forth the basis for its disagreement with the appellate court's holding – a disagreement echoed in all subsequent bankruptcy court decisions on the topic.

Like other bankruptcy courts, the *GFS* court found the preamble of §523(a), limiting the applicability of the section, to be critical. The court noted that §1192(2)'s reference to §523(a) "only incorporates the list of nondischargeable debts, without expanding it." Because §523(a) only applies to individuals, the language of §1192(2) does not allow it to "cast a wider net" than §523(a) permits.

And like the Fourth Circuit, the *GFS* court noted other sections of the Bankruptcy Code where Congress explicitly specified whether a provision applied to an individual or a corporate debtor, including §§1141(d)(2) and 1141(d)(6). Because §1192(2) does not make a distinction, however, the court felt it necessary to look to §523(a), the provision that is referenced, for guidance. Section 523(a) only applies to individuals, so the court reasoned that §1192(2) also only applies to individuals.

Addressing the Fourth Circuit's claim in *Cleary* that the language of §1192(2) should control over the language of §523(a) because the former is more specific, the *GFS* court opined that the Fourth Circuit misapplied this canon of interpretation. It said that the canon only applies when conflicting provisions cannot be reconciled; because they could be reconciled in this case, the language of §523(a) must be given meaning.

The *GFS* court also found that §1192(2) could be reconciled with §1141(d)(6) due to the context in which the two provisions operate. Section 1141 references specific subparagraphs of §523(a), whereas §1192(2) references §523(a) more broadly, with no limitations. The bankruptcy court found that this made it appropriate to interpret the same words differently.

Finally, the court in *GFS* concluded that Congress did not distinguish the type of debtors covered by §1192 because corporations generally have never been subject to dischargeability actions. Thus, because subchapter V is part of chapter 11, its interpretation should be guided by the broader statutory scheme of that chapter such that §1192 only applies to individual debtors. Likewise, the purpose of the SBRA was to facilitate reorganization for small businesses, and it would not make sense to apply §523(a) exemptions to corporations and make reorganization more difficult. Because corporate debtors in chapter 11 historically have been exempt from dischargeability actions, Congress likely intended subchapter V to operate in the same way.

Since *GFS*, bankruptcy courts have uniformly held, contrary to *Cleary*, that the discharge exceptions in §523(a) apply only to individual debtors. *See Jennings v. Lapeer Aviation, Inc.* (*In re Lapeer Aviation Inc.*), 2022 WL 1110072 (Bankr. E.D. Mich., Apr. 13, 2022); *BenShot LLC v. 2 Monkey Trading LLC* (*In re 2 Monkey Trading LLC*), 650 B.R. 521 (Bankr. M.D. Fla. 2023); *Nutrien Ag. Sols. Inc. v. Hall* (*In re Hall*), 651 B.R. 62 (Bankr. M.D. Fla. 2023). Each decision references the first sentence of §523(a) limiting its application to individual debtors and incorporating that limitation into §1192. Most recently, the Ninth Circuit BAP acknowledged the same limitation, holding that debts can be nondischargeable in subchapter V only when the debtor is an individual and distinguishing the Fourth Circuit's decision in detail. *See Lafferty v. Off-Spec Sols. LLC* (*In re Off-Spec Sols. LLC*), 2023 Bankr. LEXIS 1701, (9th Cir. BAP, July 6, 2023).

Conclusion

Clearly, there is some ambiguity in the relationship between §§1192(2) and 523(a). On its face, the language of §1192(2) appears to refer to certain debts without regard for the type of debtor. As explained by the bankruptcy courts that have examined the statutes, the better reading is that §523(a) only applies to individual debtors. Accordingly, other circuit courts should decline to follow the Fourth Circuit's decision in *Cleary*.[2]

In light of the overall statutory scheme of chapter 11, and the undisputed purpose of subchapter V to make reorganization easier for small business debtors, it is highly unlikely that in enacting §1192 Congress intended, without expressing its desire to do so, to drastically alter the dischargeability of debts for corporate debtors. Contrary to the goal of the SBRA, corporate debtors will be less likely to take advantage of subchapter V if fewer of their debts are dischargeable.

ENDNOTES:

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[2] A direct appeal of the bankruptcy court's decision in the *GFS* case presently is pending before the Fifth Circuit Court of Appeals.