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Are Nondischargeability Provisions of Section 523(a) Extended to Corporate Debtors in Chapter 11 Subchapter V Cases?

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An emerging issue facing bankruptcy courts in subchapter V — small business reorganization cases[1] — is whether the 19 categories of debts listed in section 523(a) of the Bankruptcy Code are subject to discharge in a cramdown confirmation of a corporate debtor's plan of reorganization.

Looking to the statutory text, section 1192 provides, in relevant part, that if a debtor confirms a plan under the cramdown provision of section 1191(b), then the bankruptcy court "shall grant the debtor a discharge"[2] of certain debts "except any debt…of a kind specified in section 523(a)." Section 523(a) in turn provides, in relevant part, that "[a] discharge under section…1192…of this title does not discharge an individual debtor from any debt—" of a kind specified in section 523(a)(1)-(19).

The issue is whether the limitation that is provided for in section 523(a) — that only *individual* debtors may have nondischargeable debts — is applicable to section 1192, which specifies the exceptions from discharge as a *kind of debt*, but does not expressly limit nondischargeability to a *kind of debtor*. In other words, does a corporate debtor automatically receive a discharge from section 523(a) debts under section 1192?

The answer to this question may have a major impact in chapter 11 cases and whether a qualifying small business corporate debtor will make a subchapter V election. If section 523(a) debts are excluded from discharge under section 1192, then a debtor may choose to proceed with a traditional chapter 11 reorganization (where the effect of plan confirmation would be to discharge most[3] section 523(a) debts), if the debtor would otherwise be subject to a willful or malicious injury claim or another claim that falls within the kinds of debts specified in section 523(a).[4] The determination may also impact whether a debtor's plan is feasible,[5] as a debtor will have to show that confirmation is not likely to be followed by liquidation or the need for further financial reorganization to confirm a plan based upon nondischarged debt. In addition, the expense of litigation over the nondischargeability claim may be cost prohibitive to a small business debtor.

As of the date of this blog post, only three bankruptcy cases have addressed this issue in subchapter V cases: *In re Satellite Restaurants Inc. Crabcake Factory USA*, 626 B.R. 871 (Bankr. D. Md. 2021), *In re Cleary Packaging LLC*, 630 B.R. 466 (Bankr. D. Md. 2021), and *In re Rtech Fabrications, LLC*, 2021 WL 4204800 (Bankr. D. Idaho Sept. 15, 2021), all of which have held that the dischargeability exceptions in section 523(a) apply only to individual debtors in subchapter V cases. In each case, the bankruptcy courts determined that the plain language of sections 1192 and 523(a) controlled the result because of section 523(a)'s limitation that it applies only to individual debtors and section 523(a)'s inclusion of section 1192 (i.e. "[a] discharge under section…1192…of this title does not discharge an individual debtor…").[6] The *Cleary Packaging LLC* decision is currently on direct appeal to the Fourth District Court of Appeal.

Creditors seeking to extend the nondischargeability provisions of section 523(a) to corporate small businesses in subchapter V cases have advanced two pre-SBRA chapter 12 cases: *Southwest Ga. Farm Credit, ACA v. Breezy Ridge Farms, Inc. (In re Breezy Ridge Farms, Inc.)*, 2009 WL 1514671 (Bankr. M.D. Ga. May 29, 2009) and New Venture P'ship v. JRB Consol. (*In re JRB Consol., Inc.*), 188 B.R. 373 (Bankr. W.D. Tex. 1995).[7] These cases hold that section 523(a) exceptions *do apply* to the discharge of non-individual chapter 12 debtors because the chapter 12 discharge provision of section 1228(a) excepts from discharge debts of a kind specified in section 523(a) without distinguishing between individuals and entities. The *Breezy Ridge Farms* case undertook an analysis of the types of discharges provided for under chapter 7, 12, 11, and 13 to demonstrate how Congress has "alter[ed] the applicability of § 523(a)" depending on the discharge provision. 2009 WL 1514671 at *1-2. By way of example, the court explained that in chapter 11 cases under section 1141(d)(6)(A), "[c]orporations…are not discharged from any debt 'of a kind specified in paragraph (2)(A) or (2)(B) of section 523(a)'" and "[t]hus, in Chapter 11, Congress has applied parts of § 523(a) to corporate debtors, even though such debtors are excluded from § 523(a) by its terms." Id. *2. The *Breezy Ridge Farms* court went on to explain:

> This reading of the relevant statutes adheres to the tenet that "[p]rovisions within a statute are read to be consistent whenever possible. If the two provisions may not be harmonized, then the more specific will control over the general." *Universal Am. Mortg. Co. v. Bateman (In re Bateman)*, 331 F.3d 821, 825 (11th Cir.2003) (citations omitted). In this case, § 1228 and § 523(a) can be in harmony. Although § 523(a) applies only to individuals, Congress has used it as shorthand to define the scope of a Chapter 12 discharge for corporations as well as individuals. Thus it is appropriate to rely on § 523(a) to determine whether a debt is included in the discharge, even when the debtor is a corporation. Even if the two provisions could not be harmonized, § 1228 would control because it is

more specific, applicable only in Chapter 12, than § 523(a), which applies regardless of chapter.

Id. at *2. The bankruptcy court in *Satellite Restaurants* countered *Breezy Ridge Farms* by explaining that "Section 1192 should be read in the context of Chapter 11 cases, not Chapter 12 cases, and the plain language of Section 523(a) defeats any argument that its exceptions to discharge apply to non-individual debtors." 626 B.R. at 877. [8]

For now, it remains to be seen how this issue will be determined by the courts. Debtor and creditor counsel and subchapter V trustees stand by in anticipation.

Nelson Mullins attorneys are experienced in handling bankruptcy matters of all sizes and are well equipped to advise debtors, creditors, and other stakeholders on both the legal and practical aspects of filing for subchapter V relief.

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[1] The Small Business Reorganization Act of 2019 (the "SBRA"), effective on February 19, 2020, created subchapter v of chapter 11, reforming the ability of small business debtors the ability to reorganize their financial affairs through a new reorganization process. Not to be confused with a "small business case" under section 101(51(C)).

[2] The discharge is of "all debts provided in section 1141(d)(1)(A) of this title [title 11 of the United States Code, the Bankruptcy Code] and all other debts allowed under section 503 of this title, excepting any debt on which the last payment is due after the first 3 years of the plan and provided for in the plan, except any debt- (1) on which the last payment is due after the first 3 years of the plan, or such other time not to exceed 5 years fixed by the court; or (2) of the kind specified in section 523(a) of this title." 11 U.S.C. § 1192 (Added Pub. L. 116-54, § 2(a), Aug. 23, 2019, 133 Stat. 1083).

[3] *See* 11 U.S.C. § 1141(d)(6) (not discharging a debtor that is a corporation from any debt (A) of a kind specified in section 523(a)(2)(A) or (2)(B) that is owed to a domestic governmental unit or owed to a person as a result of an action filed under subchapter III of chapter 37 of title 31 or (B) for tax or customs duty with respect to which the debtor made a fraudulent return or a willful attempt to evade)

[4] The types of debts covered by section 523(a) include certain tax and tax-related debts (section 523(a)(1), (7), (14), and (14A)), debts for monies obtained by actual fraud (section 523(a)(2)), debts for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny (section 523(a)(4)), debts obtained for willful and malicious injury by the debtor to a creditor or its property (section 523(a)(6)), debts for violations of securities laws and securities fraud (section 523(a)(19). One should be mindful of section 523(c) and Bankruptcy Rule 4007(c), which if applicable to a corporate debtor in a subchapter V case, requires that a party in interest commence a complaint to determine the dischargeability of a debt under section 523(a)(2), (4), or (6) no later than 60 days after the first date set for the meeting of creditors.

[5] Section 1129(a)(11), applicable pursuant to section 1191(b), requires that the bankruptcy court only confirm a plan if it finds that "[c]onfirmation of the plan 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 under the plan, unless such liquidation or reorganization is proposed in the plan.

[6] The courts relied upon the canon of statutory construction that every word in a statute must be given effect. The courts conclude that the necessary analysis ends with the plain language of the statutes. They then also provide additional analysis of the pre-SBRA application of section 523(a) and historical context (that corporate chapter 11 debtors were not previously excepted from discharge of section 523(a) debts) and legislative history for the SBRA

(which did not appear to address whether section 523(a) would be expanded to corporate debtors in subchapter V cases).

[7] The chapter 12 discharge provision in section 1228(a) uses the same words that appear in the subchapter V cramdown discharge provision of section 1192 (i.e., that the bankruptcy court "shall grant a discharge" but "excepting any debt-…of a kind specified in section 523(a)…"), and that section 523(a) references both 1192 and 1228(a) in the same way (i.e. "A discharge under section…1192…[and section] 1228(a)…of this title does not discharge an individual debtor from any debt…").

[8] The *Satellite Restaurants* court also noted that a bankruptcy court in *United States v. Hawker Beechcraft, Inc. (In re Hawker Beechcraft, Inc.)*, 515 B.R. 416, 430-31 (S.D.N.Y. 2014) considered *JRB Consolidated* and *Breeze Ridge Farms* and did not extend those holdings and that it agreed with the *Hawker Beechcraft* analysis. "The United States District Court for the Southern District of New York examined both cases when deciding whether Section 523(c) applies to all debtors, not just individual debtors, in relation to the traditional Chapter 11 discharge under Section 1141 of the Bankruptcy Code." *Id.* "The court concluded that the lack of distinction within Chapter 12 of an individual debtor from a corporate debtor, combined with the narrow type of corporation that may be a debtor in Chapter 12, renders any analogy between the Chapter 12 discharge provisions under Section 1228 and the Chapter 11 discharge provisions under Section 1141 inappropriate." *Id.* Note though that *Hawker Beechcraft* preceded the SBRA and that the SBRA in section 1181 made inapplicable other sections of the Bankruptcy Code and provided a special rule for discharge, providing that if a plan is confirmed under section 1191(b), then section 1141(d) shall not apply, except as provided in section 1192.

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