

BY VINCENT J. ROLDAN

## Does § 523(a) Apply to a Corporate Debtor in Subchapter V?

Discharge is said to be the “holy grail” of a corporate reorganization: “It is the *sine qua non* without which there can be no fresh start for the ‘honest but unfortunate’ debtor.”<sup>1</sup> Although a chapter 11 plan will discharge most types of debts, certain debts are deemed ineligible for discharge for public policy reasons. These debts are excepted from discharge under § 523 of the Bankruptcy Code.

Until recently, chapter 11 was too cost-prohibitive for small businesses, but Congress enacted subchapter V in the Small Business Reorganization Act in 2019 as a streamlined, less expensive alternative to traditional chapter 11 cases. The bankruptcy filing statistics show that small businesses have not only been using the new subchapter V provisions, they have been more successful in confirming chapter 11 plans than under traditional chapter 11.<sup>2</sup>

With more subchapter V activity, the related case law is still evolving. The latest issue is whether a corporate debtor in a subchapter V case is subject to the nondischargeability provisions of § 523(a). Thus far, one circuit-level court has ruled that corporate debtors are subject to § 523(a), but there are several bankruptcy courts that disagree.<sup>3</sup> The dispute centers on interpretations of § 523(a), which specifically applies to individuals, and the subchapter V discharge provisions of § 1192(2), which does not specifically distinguish between individuals and corporate debtors. The courts have analyzed these provisions, chapter 11’s history, subchapter V’s purpose and longstanding canons of statutory interpretation, and, through fulsome discussion, they have come to different conclusions.

### The Relevant Statutes

Once a debtor files for chapter 11 protection, creditors with certain types of claims (*e.g.*, fraud) typically object to the discharge. In subchapter V, § 1192(2) governs discharge and provides that:

[i]f the plan of the debtor is confirmed under section 1191(b) ... the court shall grant the

debtor a discharge of all debts provided in section 1141(d)(1)(A) ... and all other debts allowed under section 503 ... and provided for in the plan, except any debt...

(2) of the kind specified in section 523(a).

Section 523(a) lists certain types of debts that are excepted from the discharge, and provides that “(a) A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) ... does not discharge an individual debtor from any debt.”<sup>4</sup>

### Cleary Packaging

The Fourth Circuit in *In re Cleary Packaging LLC*<sup>5</sup> analyzed these provisions and ruled in the creditor’s favor, holding that a corporate debtor cannot discharge the debt listed in § 523(a). In arguments, the debtor focused on § 523(a) and asserted that because it applies to individual debtors, it limits § 1192(2). The creditor focused on § 1192(2) and how it applies to both individual and corporate debtors, yet excludes from discharge “debts of the kind” listed in § 523(a), regardless of the class of debtor.

The court noted that § 1192(2), by its terms, applies to “debt ... of the kind” specified in § 523(a); it does not apply to the “kind” of debtors discussed in § 523(a). The court concluded that Congress intended to reference only the list of nondischargeable debts in § 523(a). The U.S. government filed an *amicus* brief that aligned with this interpretation.<sup>6</sup> In addition, the *Cleary Packaging* court applied the canon that the more specific provision should govern over the more general, and found that § 523(a) was the general provision that applied to numerous discharge provisions, whereas § 1192(2) was more specific, addressing only subchapter V discharges.<sup>7</sup>

The *Cleary Packaging* court also found support for the analysis in other Bankruptcy Code sections. For example, § 1141(d)(6)(A) provides:

(6) Notwithstanding paragraph (1), the confirmation of a plan does not discharge a debtor that is a corporation from any debt —  
(A) 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



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<sup>1</sup> *In re Hyman*, 320 B.R. 493, 501 (Bankr. S.D.N.Y. 2005).

<sup>2</sup> See “Chapter 11 Subchapter V Statistical Summary Through February 28, 2023,” available at [justice.gov/ust/page/file/1499276/download](https://justice.gov/ust/page/file/1499276/download) (more than 5,000 subchapter V cases have been filed as of February 2023, and “[c]ompared to other (non-subchapter V) chapter 11 small business cases, subchapter V cases have had approximately double the percentage of confirmed plans and half the percentage of dismissals, as well as a shorter time to confirmation”) (link last visited April 25, 2023).

<sup>3</sup> Compare *In re Cleary Packaging LLC*, 36 F.4th 509 (4th Cir. 2022) (holding that discharge exceptions apply to corporate debtor in subchapter V case), with *In re GFS Indus. LLC*, 647 B.R. 337 (Bankr. W.D. Tex. 2022) (rejecting *Cleary Packaging*); *In re Hall*, 2023 WL 2927164 (Bankr. M.D. Fla. April 13, 2023) (same).

<sup>4</sup> This subsection goes on to list 21 types of debt.

<sup>5</sup> *In re Cleary Packaging LLC*, 36 F.4th 509 (4th Cir. 2022).

<sup>6</sup> *Id.* at 515.

<sup>7</sup> *Id.*

person as the result of an action filed under subchapter III of chapter 37 of title 31 or any similar State statute.

The *Cleary Packaging* court observed that § 1141(d)(6)(A) applies to corporate debtors, excluding debts “of a kind” specified in § 523(a)(2)(A) and (2)(B). The debtor could not reconcile its interpretation of § 1192(2) with any consistency as to how it would apply § 523(a) to § 1141(d)(6).

In addition, the court looked to § 1228(a), the analogous provision in chapter 12 cases. Section 1228(a) is almost identical to § 1192(2) in that they both use the “of a kind specified in section 523(a)” language. Courts construing § 1228(a) have concluded that the § 1228(a) discharge applies to both individual and corporate debtors.<sup>8</sup> Here, the court applied the canon that “identical words and phrases in the same statute should normally be given the same meaning.”<sup>9</sup>

The *Cleary Packaging* court also noted that the purpose of subchapter V was to simplify chapter 11 reorganizations for small businesses and deliberately alter provisions of traditional chapter 11 such as the absolute-priority rule.<sup>10</sup> The court believed that Congress sought to limit discharge in order to provide an “additional layer of fairness and equity” to creditors as a counterbalance to the debtor-friendly provisions of subchapter V.<sup>11</sup>

Finally, the court noted that § 1192(2) provides benefits to small business debtors regardless of whether they are individuals or corporations, unlike § 1141, which specifically distinguishes individuals and corporate debtors. Thus, the *Cleary Packaging* court concluded that subchapter V’s purpose would be frustrated if the court were to adopt the debtor’s interpretation of §§ 1192(2) and 523(a), which would treat individuals and corporations differently.<sup>12</sup>

## GFS Industries

*Cleary Packaging* was rejected by *In re GFS Industries LLC*,<sup>13</sup> which ruled that in subchapter V, only individuals and not corporations are subject to § 523(a) nondischargeability actions. The *GFS* court focused on the preamble to § 523, which contains limiting language. It states that a “discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) ... does not discharge an individual debtor from any debt.” The court found that § 1192(2) does not, by its terms, expand § 523(a), stating that, “[h]ad Congress included a phrase in § 1192(2) explicitly stating that the list found in § 523(a) applies to all debtors proceeding in Subchapter V, then the interpretation would be straightforward. Congress’s choice not to insert this language is instructive.”<sup>14</sup>

The *GFS* court also considered § 1141, and again came to the opposite conclusion as the *Cleary Packaging* court. The court observed how § 1141 distinguishes between cor-

porate and individual debtors, but § 1192(2) does not. The *GFS* court concluded that to determine to which debtor § 1192(2) applies, one must look to § 523(a), which only applies to individual debtors. The court found this interpretation consistent with the preamble of § 523(a). By including § 1192(2) in that preamble, § 523(a) now reads that a discharge under § 1192 “does not discharge an individual debtor.”<sup>15</sup> In considering the addition of § 1192 to § 523, the *GFS* court applied a different canon than the *Cleary Packaging* court: When interpreting statutes, courts should “lean in favor of a construction [that] will render every word operative, rather than one [that] may make some idle and nugatory.”<sup>16</sup>

The court also considered that historically, corporate debtors were immune from nondischargeability actions because § 523(a) applies to individuals: “For Congress to suddenly depart from this well-established principle when it enacted Subchapter V defies reason.”<sup>17</sup> At the time of the *GFS* decision, the court pointed out that there were four bankruptcy court decisions and all of them determined that § 523(a) exceptions are only applicable to individual debtors, not corporate debtors.<sup>18</sup>

As to the Fourth Circuit’s decision in *Clearly Packaging*, the *GFS* court rejected the decision because of the preamble of § 523(a) that specifically references § 1192.<sup>19</sup> The *GFS* court was also unpersuaded that the chapter 12 cases are analogous, despite similar language between §§ 1228(a) and 1192(2), because chapter 12 does not distinguish between individual and corporate discharges, and is itself only available to a limited type of entity.<sup>20</sup> Further, the *GFS* court found *Cleary Packaging* to be contrary to the longstanding policy of exempting corporations from the discharge-exception provisions of § 523.<sup>21</sup> Finally, whereas the *Cleary Packaging* court found its interpretation of § 1192(2) to be a good counterbalance to the powers of a debtor in subchapter V, the *GFS* court disagreed:

Moreover, the practical effect of making § 523(a) applicable to corporations in Subchapter V cases, but not in traditional Chapter 11 cases, would disincentivize corporations from availing themselves of the benefits of Subchapter V. The idea that Congress would aim to create a simpler option for a corporation to pursue bankruptcy while simultaneously implementing impediments to that debtor achieving a discharge of its debts defies reason.<sup>22</sup>

## Takeaways

It is interesting to see how bankruptcy courts such as *GFS* rule in one direction, and the sole circuit-level court ruled in the opposite direction. Although not specifically stated by *GFS*, perhaps bankruptcy courts are mindful of another

15 *Id.* at 343.

16 *Id.*

17 *Id.* at 344.

18 *Id.* at 346.

19 *Id.* at 347.

20 *Id.* at 349.

21 *Id.*

22 *Id.*

8 *Id.* at 516 (citations omitted).

9 *Id.* at 516-17 (citations omitted).

10 *Id.* at 517.

11 *Id.*

12 *Id.*

13 *In re GFS Indus. LLC*, 647 B.R. 337 (Bankr. W.D. Tex. 2022).

14 *Id.* at 342-43.

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## ***On the Edge: Does § 523(a) Apply to a Corporate Debtor in Subchapter V?***

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often-quoted policy: Exceptions to discharge are to be narrowly construed against the creditor.<sup>23</sup>

This type of litigation will likely continue to evolve as debtors continue to use subchapter V as an alternative to a traditional chapter 11. If it is eligible, a small business debtor would likely choose to use subchapter V rather than a tradi-

tional chapter 11. For now, practitioners should be aware that in the Fourth Circuit, the prevailing law is that a corporate debtor in subchapter V is subject to § 523(a). **abi**

**Editor's Note:** *ABI's newly formed Subchapter V Task Force (see p. 45) is seeking input from those who have had experience working with subchapter V. To participate in a survey on subchapter V, please visit [abi.org/subvsurvey](http://abi.org/subvsurvey).*

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<sup>23</sup> See *In re Segal*, 57 F.3d 342, 346 (3d Cir. 1995).

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