ANALYSIS

Fifth Circuit Weighs In, Finds Section 523(a) Applies to Corporate Debtor in Subchapter V

The Fifth Circuit, in 'In re GFS Industries', recently issued a decision siding with the controversial 'Cleary Packaging' decision. All of a sudden, the subchapter V debtor's efforts to use a streamlined procedure could be undermined by Section 523(a) litigation even outside the Fourth Circuit.

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Bankruptcy

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The goal of most corporate reorganization cases is for the company to obtain a "discharge" of its debts, and obtain a "fresh start." Though 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 Section 523(a) of the Bankruptcy Code.

In 2019, Congress enacted subchapter V in the Small Business Reorganization Act as a streamlined, less expensive alternative to traditional Chapter 11 cases. Case law is still evolving under this relatively new law; the latest issue is whether a corporate debtor in a subchapter V case is subject to the non-dischargeability provisions of Section 523(a).

In a controversial decision, the U.S. Court of Appeals for the Fourth Circuit, in *In re Cleary Packaging*, ruled that corporate debtors are subject to Section 523(a). Subsequent bankruptcy courts outside the Fourth Circuit, as well as the U.S. Court of Appeals for the Ninth Circuit Bankruptcy Appellate Panel (BAP), criticized the decision. For a period of time, it appeared that practitioners did not have to worry about the *Cleary Packaging* decision outside the Fourth Circuit.

The U.S. Court of Appeals for the Fifth Circuit, in *In re GFS Industries,* however, recently issued a decision siding with the controversial *Cleary Packaging* decision. All of a sudden, the subchapter V debtor's efforts to use a streamlined procedure could be undermined by Section 523(a) litigation even outside the Fourth Circuit.

Armed with two circuit-level decisions, creditors who lose at the bankruptcy court level may feel encouraged to appeal. As of now, no court in the Second Circuit has addressed the issue and it remains to be seen how other courts will react.

Relevant Statutes

Once a debtor files for Chapter 11 protection, creditors with certain types of claims (for instance, fraud) typically object to the discharge. In subchapter V, Section 1192(2) governs discharges and provides:

> If the plan of the debtor is confirmed under Section 1191(b) of this title,…the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) of this title…except any debt…
>
> (2) of the kind specified in Section 523(a) of this title.

11 U.S.C. Sec. 1192(2).

Section 523(a) of the Bankruptcy Code lists certain types of debts that are excepted from discharge, providing:

> (a) A discharge under Section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt [lists 21 types of debt].

11 U.S.C. Sec. 523(a).

The dispute centers on interpretations of Section 523(a) (which specifically applies to individuals) and the subchapter V discharge provisions of Section 1192(2) (which does not specifically distinguish between individuals and corporate debtors).

‘GFS Industries’ Adopts ‘Cleary Packaging’

The Fifth Circuit, in *GFS Industries*, largely adopted the reasoning of the Fourth Circuit in *Cleary Packaging,* and ruled in favor of the creditor such that the corporate debtor cannot discharge debts listed in Section 523(a). The court noted that Section 1192(2), by its terms, applies to “debt…of the kind” specified in Section 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 non-dischargeable debts in 523(a).

In addition, the *GFS Industries* court applied the canon that the more specific provision should govern over the more general. The court found that Section 523(a) was the general provision that “cuts across” various provisions; Section 1192(2) was more specific, addressing only subchapter V discharges.

The debtor in *GFS Industries* asserted that the court’s interpretation of Section 1192(d) would make the word “individual” in Section 523(a) superfluous. The court did recognize the long-standing cannon of statutory interpretation that “every word and every provision of a statute is to be given effect, and none should be ignored.”

However, the Fifth Circuit went on to state that “at the same time, though, the preference for avoiding surplusage constructions is not absolute” and “[t]he canon requiring a court to give effect to each word ‘*if possible*’ is sometimes offset by the canon that permits a court to reject words ‘as surplusage’ if ‘inadvertently inserted or if repugnant to the rest of the statute.’”

The *GFS Industries* court found support in other Bankruptcy Code sections. For instance, the court observed that Section 1141(d)(6)(A) applies to corporate debtors, excluding debts “of a kind” specified in Section 523(a)(2)(A) and (2)(B). Interpreting “individual” in Section 523(a) to control the cross-referenced statutes would erase the corporate discharge exceptions in Section 1141(d)(6).

Further, the *GFS Industries* court relied on Section 1228(a), the analogous provision in Chapter 12 cases. Section 1228(a) is almost identical to Section 1192(2) in that they both use the “of a kind specified in Section 523(a)” language. Courts construing Section 1228(a) have concluded that the 1228(a) discharge applies to both individual and corporate debtors. Here, the court applied the canon that “identical words and phrases in the same statute should normally be given the same meaning.”

Finally, the *GFS Industries* court considered compromises inherent in subchapter V, including how unlike a traditional chapter 11, there is no absolute priority rule in subchapter V. The court believed that Congress deliberately afforded small businesses the benefits of subchapter V, while subjecting them to the dischargeability exceptions of Section 523(a).

Ninth Circuit BAP and Bankruptcy Court Level Decisions

A recent Ninth Circuit BAP decision, *In re Off-Spec Solutions,* went the opposite direction and criticized *Clearly Packaging*. The court, in *Off-Spec Solutions*, held that "the language and context of the relevant statutes indicate Congress's intent to make §523(a) applicable in subchapter V only to individual debtors*."*

Further, the court noted that "bankruptcy courts that have confronted the issue have uniformly concluded, as the court did here, that Section 1192 does not make Section 523(a) applicable to corporate debtors. Indeed, the court pointed out how bankruptcy courts in Florida, Michigan and Maryland, as well as the two lower bankruptcy courts in the *GFS Industries* and *Cleary Packaging* cases, all ruled in favor of the debtor.

The *Off-Spec* court stated that "the apparent difference between the discharge provisions does not entice us to reject the language and context of the statutes in favor of an interpretation that alters the long-standing operation of Section 523(a) without an express indication by Congress—in the statute or otherwise—that it intended to do so." It reasoned that preventing discharge of these debts would not "comport with the purpose of facilitating reorganization of small businesses."

Moreover, "under the *Cleary* interpretation, a small business debtor with potentially nondischargeable debts is incentivized to elect subchapter V and force creditors to spend resources to prove their claims, only to then amend its election and proceed under Chapter 11 where those claims will be discharged upon confirmation."

The court further found the policy rationales suggested by the creditor were unavailing. Construing Section 1192 to make debts nondischargeable for corporate debtors offers little benefit to unsecured creditors in small business cases and poses serious obstacles to the stated purpose of the SBRA to make reorganization efficient and expeditious for small business debtors."

Takeaways

It is interesting to see how bankruptcy courts rule in one direction, and two circuit-level court ruled in the exact opposite direction. Perhaps the bankruptcy courts are more mindful of another oft-quoted policy, that exceptions to discharge are to be narrowly construed against the creditor.

Over time, other circuits—including the Second Circuit—may weigh in, as debtors continue to use subchapter V as an alternative to a traditional Chapter 11. Indeed, a small business debtor would likely choose to use subchapter V (if it is eligible) rather than a traditional Chapter 11. In turn, creditors may seek application of *GFS Industries* and *Cleary Packaging*.

For now, practitioners should be aware that in the Fourth and Fifth Circuits, the prevailing law is that a corporate debtor in subchapter V is subject to Section 523(a), limiting dischargeability of certain debts thereby significantly impacting the reorganization.

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