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LEGAL ALERT

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THE SMALL BUSINESS THAT DEFRAUDED ME HAS COMMENCED A SUBCHAPTER V BANKRUPTCY CASE. CAN I RENDER THAT DEBT NON-DISCHARGEABLE?

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Introduction

Lenders and businesses are all too familiar with the unscrupulous contract counterparty. Consider Bob, who runs Bob's Copy Service, Inc. Bob obtains a loan from Community Bank, using fraudulent financial statements to convince the bank to extend credit. When Bob's Copy Service, Inc. defaults on the loan, Community Bank secures a $4 million fraud judgment. However, Bob's Copy Service, Inc. promptly files for bankruptcy, seeking to discharge the judgment.

Traditionally, a Chapter 11 business debtor would be able to discharge that debt notwithstanding that it was obtained through fraud, as section 523(a) of the United States Bankruptcy Code (the "Bankruptcy Code") renders that type of debt non-dischargeable as against individual debtors only. However, Congress may have expanded the applicability of section 523(a) to include qualifying small businesses that elect to proceed under Subchapter V of the Bankruptcy Code, a creature of the Small Business Reorganization Act of 2019 ("SBRA"). Section 1192 of the Bankruptcy Code, which governs non-consensual plan confirmations in Subchapter V cases, incorporates 523(a) without any limiting language regarding application, possibly affording the Community Bank in the example with some remedies.

The applicability of section 523(a) to small business entities in bankruptcy proceedings filed under Subchapter V of Chapter 11 of the Bankruptcy Code is unsettled and hotly contested. Courts

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diverge in their analysis regarding the applicability of section 523(a) to corporate debtors. That said, in *In re Cleary Packaging*, the Fourth Circuit Court of Appeals rendered a decision broadly applying section 523(a) to business entities in Subchapter V cases in a manner consistent with the statutory text of section 1192(2) and which advances the public policies underpinning the Bankruptcy Code, namely that of providing only an honest debtor with a fresh start.

Understanding the Non-Dischargeability Issues Within the Context of Subchapter V

Section 523(a) of the Bankruptcy Code enumerates specific categories of debts that are excepted from discharge, including debts arising from fraud, embezzlement, and willful injury. Historically, this provision has applied only to individual debtors. Corporate debtors, on the other hand, generally receive broader discharge protections in Chapter 11 proceedings, where only a limited subset of debts may be excepted from discharge under section 1141(d)(6). However, the creation of Subchapter V under the SBRA introduced a new category of business bankruptcies specifically tailored for small businesses, raising questions about whether the more specific discharge limitations of section 523(a) should also apply to business entities within the subchapter.

In essence, Subchapter V cases are Chapter 11 proceedings for small businesses. The requirements and provisions of Subchapter V are theoretically less cumbersome than those in traditional chapter 11 cases and they allow for equity holders to more easily retain their interest in a business debtor. For example, non-consensual reorganization plans in traditional Chapter 11 cases are subject to the absolute priority rule. The absolute priority rule requires that creditors with higher priority be paid in full before any payment is made to junior creditors. Under this rule, equity holders cannot retain any ownership interest in the debtor unless all non-consenting creditors, including unsecured creditors, are fully compensated. However, in Subchapter V cases, a debtor can confirm a non-consensual reorganization plan without adhering to the absolute priority rule. This allows small business owners to retain ownership and continue operating their businesses, even if all creditors have not been paid in full and those creditors do not consent to the reorganization plan.

In re Cleary Packaging: The Facts and Holding

In *Cleary Packaging*, the Fourth Circuit was tasked with determining whether a corporate debtor's discharge in a Subchapter V case involving a non-consensual plan should be subject to the same

non-dischargeability provisions as an individual under section 523(a). The creditor in that case sold office products. The debtor was formed by the former president and CEO of the creditor after his departure from the business. In leaving the creditor, the former CEO took with him sensitive and proprietary client lists and customer information, as well as multiple employees who were subject to noncompetition agreements. The debtor competed with the creditor.

The creditor initiated a lawsuit asserting claims for intentional interference with contracts, tortious interference with business relations, and other related claims. The creditor obtained a $4.7 million judgment against the debtor on those claims. In response to the judgment, the debtor sought protection by filing for bankruptcy under Subchapter V of Chapter 11, which is designed to streamline the reorganization process for small businesses.

The creditor sought to have the judgment deemed non-dischargeable pursuant to section 523(a)(6) of the Bankruptcy Code, which excepts from discharge debts arising from "willful and malicious injury by the debtor." The debtor, on the other hand, argued that section 523(a) only applies to individual debtors and, therefore, cannot apply to the debtor, a business entity. The bankruptcy court agreed with the debtor, and the creditor appealed.

The Fourth Circuit disagreed with the debtor and the bankruptcy court, holding that the discharge exceptions under section 523(a) do, in fact, apply to a business entity in a Subchapter V case.

The Fourth Circuit's Textual Analysis of Section 523(a) in the Context of Subchapter V

In reaching its conclusion, the Fourth Circuit drew a distinction between language in section 523(a) that limited its application to a specific "kind" of debt and the language in section 1192 that suggested application to all kinds of debtors. More specifically, the court noted that section 1192(2), by its terms, applies to "debt ... of the kind" specified in section 523(a), rather than applying to the "kind" of debtors, i.e. individuals, mentioned in section 523(a). In reliance upon this language, the Fourth Circuit concluded that Congress intended to reference only the list of nondischargeable debts in section 523(a).

The court also analyzed analogous provisions in reaching and justifying its broad application of section 523(a). By way of illustration, the Fourth Circuit pointed to section 1141(d)(6)(A) of the Bankruptcy Code, which excepts from discharge certain debts owed to governmental units, only

as they concern corporate debtors. That language evinced an intention by Congress to limit section 1141(d)(6)(A) to corporate debtors, whereas the intent is seemingly absent in section 1192(2).

The Fourth Circuit also referenced section 1228(a) of the Bankruptcy Code, an analogous provision applicable to Chapter 12 cases involving family farmers and fishers. Both section 1228(a) and section 1192(2) contain the phrase "of a kind specified in section 523(a)," and courts interpreting section 1228(a) have held that the discharge provisions apply to corporate debtors.

Thus, from a purely textual perspective, the Fourth Circuit found ample support for applying section 523(a) to a business debtor in the context of a non-consensual Subchapter V plan.

Public Policy Considerations

In addition to textual arguments, the Fourth Circuit was cognizant of certain policy considerations supporting application of section 523(a) to business entities in Subchapter V cases.

The Fourth Circuit observed that the purpose of Subchapter V was to streamline and simplify Chapter 11 reorganizations for small businesses and deliberately alter provisions of traditional Chapter 11 such as the absolute priority rule, with the hopes that Subchapter V cases would be quicker and less expensive. Given the elimination of the absolute priority rule and traditional cramdown procedures, both of which were designed to protect creditors, the court found that "Congress understandably applied limitations on the discharge of debts to provide an additional layer of fairness and equity to creditors to balance against the altered order of priority that favors the debtor." In essence, application of section 523(a) to business debtors acts as a counterbalance to the leniencies and advantages conferred upon debtors by Subchapter V.

As such, the Fourth Circuit found that broad application of section 523(a) in Subchapter V cases is consistent with the policies of the Bankruptcy Code and, more specifically, Subchapter V itself.

Conclusion

The decision in *In re Cleary Packaging* applies section 523(a) to business entities in Subchapter V bankruptcy cases in a manner consistent with both the textual framework of Subchapter V, which merges elements of individual and corporate bankruptcy, and the underlying public policy goal of holding debtors accountable for wrongful conduct.

The purpose of section 523(a) is to prevent debtors from escaping liabilities for debts incurred through fraudulent or morally culpable behavior. While large corporate bankruptcies may be less personal in nature, the types of businesses that file under Subchapter V are often closely-held, family-owned enterprises where there is little distinction between the owners and the company. Allowing these types of entities to discharge debts incurred through fraud or willful injury would undermine the creditor protections that are a cornerstone of bankruptcy law. Subchapter V was intended to make bankruptcy more accessible to small businesses without reducing accountability for wrongful conduct.

In light of the hybrid nature of Subchapter V, applying section 523(a) to business entities strikes the appropriate balance between providing relief for struggling businesses and protecting creditors from fraudulent or malicious behavior. Congress's intent in passing the SBRA was to create a *fair* and efficient process for small businesses, and applying section 523(a) in this context helps advance that goal.

Recently, the Fifth Circuit, in *In re GFS Industries*, largely adopted the reasoning of the Fourth Circuit and ruled that section 523(a) of the Bankruptcy Code applies to corporate debtors. This decision may suggest a growing consensus among Circuit Courts regarding section 523(a)'s broad application.

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