Business CREDIT
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A BIG WIN FOR CREDITORS OF SMALL BUSINESS DEBTORS

Another US Circuit Court Holds Exceptions to Discharge Apply to Corporate Subchapter V Debtors

SINCE ITS ENACTMENT IN FEBRUARY 2020, SUBCHAPTER V OF CHAPTER 11 HAS BECOME A USEFUL VEHICLE FOR SMALL BUSINESSES THAT ARE LOOKING TO REORGANIZE OR OTHERWISE ADDRESS OPERATIONAL ISSUES, LIQUIDITY ISSUES, OR EXCESSIVE DEBT THROUGH INSOLVENCY PROCEEDINGS. CONGRESS ENACTED SUBCHAPTER V TO MAKE CHAPTER 11 MORE APPEALING FOR SMALL BUSINESSES THAT WERE PREVIOUSLY DETERRED FROM FILING DUE TO THE COSTS AND RISKS ASSOCIATED WITH THE "TRADITIONAL" CHAPTER 11 PROCESS. SUBCHAPTER V HAS BEEN A HIT AMONG ELIGIBLE DEBTORS: IN 2023, NEARLY HALF OF ALL CHAPTER 11 FILINGS WERE UNDER SUBCHAPTER V.

Why has Subchapter V been so well received by small business debtors? Well, because it provides a less expensive and more streamlined version of the traditional Chapter 11 process, yet gives debtors the ability to reap largely the same benefits of a traditional Chapter 11. So, it is no wonder that small business debtors have embraced Subchapter V. But everything comes at a cost, and in Subchapter V, unsecured creditor swept into a streamlined Chapter 11 process have borne that cost.

In a huge win for creditors that helps balance Subchapter V's pro-debtor provisions, the U.S. Court of Appeals for the Fifth Circuit has recently held that the Bankruptcy Code's exceptions to discharge apply where a nonconsensual plan is pursued by a corporate Subchapter V debtor (even though the exceptions do not apply to corporate debtors in "traditional" Chapter 11 cases). In doing so, the Fifth Circuit joined the only other Circuit-level court to address the issue, the Fourth Circuit, bucking what appeared to be a growing trend among lower courts that have held the exceptions to discharge do not apply to corporate Subchapter V debtors.

There may be an impending drop-off in Subchapter V filings because the debt limit for filing Subchapter V bankruptcy reverted to approximately $3 million on Friday, June 21, 2024 (a significant decrease from the temporary $7.5 million limit set in 2020 due to the financial distress caused by the pandemic). However, the possibility always exists that Congress will revisit the debt limit in the future given the popularity of Subchapter V among debtors and bankruptcy professionals.

In any event, creditors should remain mindful of the various advantages that Subchapter V provides to debtors. For example, in Subchapter V: (i) the debtor maintains the exclusive right to file a plan, (ii) the debtor may extend payment of administrative expense claims (e.g., claims for goods sold on credit during the bankruptcy case) over the 3-5 year life of the plan, and (iii) the absolute priority rule is abrogated in that equity holders may retain their equity interests in the debtor even if unsecured creditors are not paid in full so long as the debtor contributes its "projected disposable income" to fund plan distributions over the life of the plan. While the exceptions to discharge apply only with respect to certain, limited categories of debts, the advantages for a Subchapter V debtor will have an impact on the overwhelming majority (if not all) Subchapter V cases. Therefore, it is critical that creditors monitor and vigorously protect their interests in Subchapter V cases just as they would in a traditional Chapter 11.

KEY POINTS

- **Subchapter V offers a** less expensive and more streamlined version of the traditional Chapter 11 process.
- **Subchapter V has been a** massive hit among debtors, with nearly half of all Chapter 11 filings in 2023 being under this provision.
- **While Subchapter V offers** significant advantages to debtors—such as the exclusive right to file a plan, the lack of an official committee of unsecured creditors, the ability to defer payment of administrative expense claims over the life of the plan, and the ability to retain equity Interests even if unsecured creditors are not paid in full—these benefits come at a cost to the unsecured creditors who are swept into the streamlined process.
- **In a crucial win for creditors** that helps balance some of the above costs, the U.S. Court of Appeals for the Fifth Circuit ruled that the Bankruptcy Code's exceptions to the discharge of certain debts apply to corporate Subchapter V debtors pursuing a nonconsensual plan.

THE SPLIT REGARDING SECTION 523(A)'S EXCEPTIONS TO DISCHARGE

Section 523(a) of the Bankruptcy Code lists numerous types of debt that may be excepted from the discharge granted to a debtor in bankruptcy. Section 523(a) states that a discharge under Chapter 7, Chapter 11, Subchapter V, Chapter 12, and Chapter 13 of the Bankruptcy Code "does not discharge **an individual debtor** from any debt" for, among other things, debts that arise from a fraud, misrepresentation, materially false financial statements, defalcation in a fiduciary capacity, embezzlement, or a willful and malicious injury by the debtor. Section 523(a) specifically states that its exceptions to discharge apply to an "individual debtor" and the Chapter 11 provision that incorporates Section 523(a) into Chapter 11 cases (Section 1141(d)) does the same. As a result, corporate Chapter 11 debtors are usually not subject to Section 523(a)'s exceptions to discharge in traditional Chapter 11 cases.

Courts are split as to whether Section 523(a) applies to corporate debtors in small business Subchapter V cases. Although Section 523(a) specifically states that its exceptions only apply to "individual" debtors, Subchapter V's discharge provision, Section 1192, does not draw any distinction between individual and corporate debtors. Rather, Section 1192 states that where a nonconsensual plan is confirmed, "a debtor" is not entitled to a discharge of any debt "of the kind" specified in Section 523(a). In light of this, the U.S. Court of Appeals for the Fourth Circuit issued a decision in June 2022, in *Cantwell-Cleary Co., Inc. v. Cleary Packaging, LLC*, holding that Section 523(a)'s exceptions to discharge apply to individual and corporate debtors. The Fourth Circuit relied on Section 1192's broader language, further noting that Section 1192 is phrased virtually the same as Chapter 12's discharge provision, which has been interpreted to apply Section 523(a)'s exceptions to discharge to both corporate and individual debtors. The Fourth Circuit also reasoned that Congress had intended Subchapter V's small business provisions to generally apply to qualifying individual and corporate debtors alike, and Congress' intent would be frustrated if the discharge exceptions applied to one but not the other.

However, several courts, including in the Ninth Circuit, Michigan, Idaho and Maryland, have held the opposite—that the exceptions to discharge only apply to individual debtors, even in the Subchapter V context. For example, in its July 2023 decision in *Lafferty v. Off-Spec Solutions, LLC*, the Ninth Circuit Bankruptcy Appellate Panel (BAP) rejected the Fourth Circuit's ruling and held that Section 523(a)'s exceptions to discharge do not apply to corporate Subchapter V debtors. The Ninth Circuit BAP noted that while Section 1192 is silent on the types of debtors that are subject to Section 523(a), it says nothing to contradict that Section 523(a) is limited to individual debtors. In fact, when Congress amended Section 523(a) to include Section 1192 among the various discharge provisions to which Section 523(a)'s exceptions apply, Congress did not amend Section 523(a)'s limitation to individual debtors. The Ninth Circuit BAP concluded that Section 1192 should not be read as expanding Section 523(a)'s applicability to corporate debtors. As the Ninth Circuit BAP noted, limiting Section 523(a) to individual debtors is more consistent with the overall statutory scheme of Chapter 11.

In a win for creditors, the Fifth Circuit's decision in *GFS Industries* helps swing the tide in creditors' favor in Subchapter V cases, as it provides another Circuit court opinion that sides with the Fourth Circuit's holding that the exceptions to discharge apply to corporate debtors (where a nonconsensual plan is confirmed). [1]

CONGRESS ENACTED SUBCHAPTER V TO MAKE CHAPTER 11 MORE APPEALING FOR SMALL BUSINESSES THAT WERE PREVIOUSLY DETERRED FROM FILING DUE TO THE COSTS AND RISKS ASSOCIATED WITH THE "TRADITIONAL" CHAPTER 11 PROCESS.

BACKGROUND REGARDING THE *GFS INDUSTRIES* CASE

In April 2022, GFS Industries entered into a financing agreement with Avion Funding pursuant to which Avion Funding provided $190,000 to GFS in exchange for approximately $300,000 of GFS's future receivables. As part of the agreement, GFS represented that it had not filed and did not anticipate filing any Chapter 11 bankruptcy petition. Despite that representation, GFS filed a Subchapter V bankruptcy petition on Apr. 21, 2022—two weeks after entering into its agreement with Avion.

On July 25, 2022, Avion filed an adversary complaint against GFS seeking a declaration that the debt GFS owed Avion was nondischargeable under Section 523(a) because it arose from misrepresentations made by GFS. In response, GFS argued that Section 523(a) is inapplicable to corporate Subchapter V debtors. The bankruptcy court ruled in favor of GFS based on other court rulings that the discharge exceptions apply only to individual Subchapter V debtors. Avion appealed the decision directly to the U.S. Court of Appeals for the Fifth Circuit.

THE FIFTH CIRCUIT'S DECISION

The Fifth Circuit overruled the bankruptcy court, holding that Section 523(a)'s exceptions to discharge also apply to corporate debtors in Subchapter V cases with nonconsensual plans.[2] In so doing, the Court addressed a few key points:

- **Placing controlling weight on the word "individual" in Section 523(a) disregards Section 1192's plain language.** The Fifth Circuit noted Section 1192 governs the debts of any debtor without making any distinction between corporate and individual debtors. Also, Section

1192 excepts from discharge any debt "*of the kind* specified in [S]ection 523(a)." As the Fourth Circuit stated in *Cleary Packaging*, "[T]he combination of the terms 'debt' and 'of the kind' indicates that Congress intended to reference only the *list of nondischargeable debts* found in [Section] 523(a)." And, since Section 1192 is the more specific provision (in that it relates specifically to Subchapter V while Section 523(a) covers multiple Chapters), any ambiguity should be resolved in favor of Section 1192's language.

- **Section 523(a)'s usage of the word "individual" may be disregarded in Subchapter V cases, even though Congress left the word in the statute as is.** The Fifth Circuit disagreed with the Ninth Circuit BAP's view that courts should rely on Congress's failure to address (i.e., remove) the word individual when adding Section 1192 to the list of statutes impacted under Section 523(a). As the Fifth Circuit explained, Congress added the reference to Section 1192 via a "conforming amendment" and it would have been a significant task to heavily revise Section 523(a) to avoid any confusion with the broader impact of Section 1192. The Fifth Circuit noted that Chapter 11's relevant provision (Section 1141(d)) specifically states that a Chapter 11 discharge does not discharge a corporate debtor from certain kinds of debts in Section 523(a); if it were a given that Section 523(a) only applies to individuals across all chapters of the Bankruptcy Code, it would have been unnecessary for Section 1141 to clarify that point further in its own provisions.
- **Chapter 12's discharge provision is virtually identical to Section 1192 and has been interpreted to apply Section 523(a)'s discharge exceptions to corporate debtors.** The Fifth Circuit agreed with the Fourth Circuit that Section 1192 should be construed the same as Section 1228, which is generally interpreted as applying the exceptions to discharge to both corporate and individual Chapter 12 debtors.
- **Applying the exceptions to discharge to corporate debtors is consistent with the intent behind Subchapter V.** Critically, the Fifth Circuit viewed its interpretation as upholding an important compromise made in exchange for benefits given to a Subchapter V debtor over a traditional Chapter 11 debtor. Subject to certain limited exceptions, a nonconsensual plan cannot be confirmed in a traditional Chapter 11 case unless the plan complies with the "absolute priority rule"—i.e., each class of creditors is paid in full before any junior class receives a distribution. As a result, equity holders cannot retain their interests unless unsecured creditors are paid in full (subject to certain exceptions), which is a huge deterrent for small business owners.

Congress eliminated this deterrent in Subchapter V through Subchapter V's abrogation of the absolute priority rule in the context of nonconsensual plans. Equity holders may retain their interests, even if unsecured creditors are not paid in full, so long as the debtor's projected disposable income is paid to creditors over the three-to-five year life of a plan. The compromise? According to the Fifth Circuit, it is to subject corporate Subchapter V debtors with nonconsensual plans to Section 523(a)'s exceptions to discharge. BC

1. Notably, less than a month after issuance of the GFS Industries *opinion, a bankruptcy court in Oregon, in* Ivanov v. Van's Aircraft*, followed the Fourth and Fifth Circuits' rulings that the exceptions to discharge apply to corporate Subchapter V debtors. This further solidifies this creditor-friendly view on the issue, particularly since Oregon is within the Ninth Circuit and still did not follow the Ninth Circuit BAP's prior ruling.*

2. Subchapter V debtors with consensual plans are subject to Section 1141(d), where Section 523(a)'s exceptions to discharge apply only to individual debtors.

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IT IS CRITICAL THAT CREDITORS **MONITOR AND VIGOROUSLY PROTECT THEIR INTERESTS IN SUBCHAPTER V CASES** JUST AS THEY WOULD IN A TRADITIONAL CHAPTER 11.