

Corporate Subchapter V Debtors Beware: Creditors May Object to Dischargeability of Fraud and Other Claims, at Least in Some Jurisdictions

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On June 7, 2022, the U.S. Court of Appeals for the Fourth Circuit (“4th Circuit”) held that the discharge exceptions in Subchapter V of Chapter 11 (enacted as part of the Small Business Reorganization Act (“SBRA”)) apply to both individual debtors and corporate debtors. *Cantwell-Cleary Co., Inc. v. Cleary Packaging, LLC* (In re Cleary Packaging, LLC), 36 F.4th 509 (4th Cir. 2022).

The 4th Circuit’s decision reversed the bankruptcy court’s “nicely crafted opinion,” which held that the exceptions to dischargeability incorporated into the Subchapter V provisions of Chapter 11 applied only to individual debtors. The 4th Circuit’s decision is a big deal in the bankruptcy world because it is the first decision to hold that corporate Chapter 11 debtors are subject to all discharge exceptions under Section 523(a) of the Bankruptcy Code.

In this case, the debt at issue was a \$4.7 million judgment against the debtor for intentional interference with contracts and tortious interference with business relations. Section 523(a) of the Bankruptcy Code is the section relied upon by creditors objecting to certain types of debts, including for fraud, breach of fiduciary duty and willful and malicious injury. That section refers to dischargeability exceptions of an “individual debtor.” Section 1192, which applies only in Subchapter V cases, excepts from discharge debts “of the kind specified in section 523(a).” In holding that the Section 1192 dischargeability exception applies equally to corporate debtors, the 4th Circuit found that Section 1192 referred to “kinds” of debts as opposed to “kinds” of debtors.

This decision is controlling precedent only in Maryland, Virginia, West Virginia, North Carolina and South Carolina. Bankruptcy courts in Idaho and Michigan have held that the discharge exceptions in Subchapter V apply only to individual debtors. It will take time before there are any potentially conflicting circuit decisions on this issue that could result in review by the U.S. Supreme Court. In the meantime, this author understands that certain groups may lobby Congress for a legislative fix to the 4th Circuit’s decision, which some believe will lead to unintended consequences at odds with the legislative history of Subchapter V.

What are the potential unintended consequences? In *Cantwell-Cleary*, the National Association of Bankruptcy Trustees (“NABT”) filed a brief in support of appellee’s petition for rehearing en banc, which the 4th Circuit denied. In that brief, the NABT argued that the purpose of the SBRA was to “streamline the bankruptcy process by which small business debtors reorganize and rehabilitate their financial affairs.” The NABT argued, among other things, that by allowing claims under § 523(a) to proceed against corporate, small business debtors, Subchapter V cases will no longer proceed in a timely, cost-effective manner, nor will it help these companies remain in business. This may be true.

For example, in a hypothetical case in which a creditor has a \$4.7 million claim (that is not subject to a discharge exception), the debtor could confirm a plan (over the objection of creditors) that pays unsecured creditors only \$100,000 if the debtor's assets are not worth more than \$100,000 and if the debtor does not generate more than \$100,000 in projected disposable income over the plan term. That debtor could obtain a fresh financial start. By contrast, if that \$4.7 million claim is nondischargeable, the debtor will be burdened with collection efforts and may not actually be able to survive. Indeed, the creditor with a nondischargeable claim ends up with significant leverage against the Subchapter V debtor trying to negotiate a consensual plan. Only time will tell whether other courts will follow the 4th Circuit and/or whether someone can convince Congress to clarify whether the discharge exceptions in Section 523(a) of the Bankruptcy Code apply to corporate Subchapter V debtors.

For information on this topic, contact [Stephen Metz](#).