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Discharge of Small Business Debts

The federal bankruptcy statute provides for different levels of debt relief depending on the type of debtor and the chapter under which a debtor seeks relief. For example, under Chapter 7 of the statute, a corporate debtor receives no discharge at all, and an individual debtor receives a discharge subject to 21 exceptions, such as taxes, alimony, intentional injury or debts incurred by fraud. By contrast, in a Chapter 11 case, a corporate debtor that continues operating its business after confirmation of a plan receives a discharge of all debts without exception, and an individual debtor receives a discharge subject to the 21 exceptions.

In 2019, Congress enacted Subchapter V of Chapter 11, entitled Small Business Debtor Reorganization. Section 1192 of that subchapter grants a small business debtor (without distinguishing between a corporate debtor and an individual debtor) a discharge “except any debt... of the kind specified in section 523(a)...” However, section 523(a) states: “A discharge under section... 1192... does not discharge an individual debtor from” the 21 exceptions. This inconsistency leaves it unclear whether a corporate small business debtor under Subchapter V receives a discharge with or without the 21 exceptions.

Last year, a federal appellate court in Richmond was asked to resolve this statutory ambiguity. Disagreeing with the bankruptcy judge, the appellate court concluded that the better interpretation of the statute treated corporate small business debtors under Subchapter V just like individuals – both are subject to the 21 exceptions to discharge. *Cantwell Cleary Co. v. Cleary Packaging, LLC (In re Cleary Packaging, LLC)*, 36 F.4th 509 (4th Cir. 2022).

Employer Mandate not Penalty

Under the Affordable Care Act, larger employers are required to provide health insurance for their employees. If

employees are not provided with minimum essential health insurance coverage, the IRS may charge the employer a shared responsibility payment (“ESRP”). The ESRP is colloquially referred to as the employer mandate.

Creative Hairdressers filed a Chapter 11 petition in 2020. The IRS filed a claim for ESRP owed by the company and asserted priority status. Creative Hairdressers objected to the priority status, arguing that the ESRP is a penalty not entitled to priority.

A Maryland bankruptcy judge sided with the IRS. The judge noted that “a tax is an enforced contribution to provide for the support of government; a penalty, as the word is here used, is an exaction imposed by statute as punishment for an unlawful act.” The ESRP is paid to the treasury, collected by the IRS, and does not punish unlawful conduct. The amount is proportionate to the employees who lack health insurance rather than punitive. The ACA leaves the employer with a choice – provide adequate, affordable health coverage to employees or pay the ESRP. The court concluded that the ESRP is a tax entitled to priority, not a penalty.

In re Creative Hairdressers, 639 B.R. 320 (Bankr. D. Md. 2022).



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