By Kathleen L. DiSanto and Luis E. Rivera II[1]

Applying § 523 to Corporate Sub V Debtors: A Conscious Policy Decision, or a Drafting Oversight?

Coordinating Editor Kathleen L. DiSanto
Bush Ross, PA
Tampa, Fla.

Luis E. Rivera II
GrayRobinson, PA
Fort Myers, Fla.

Kathleen DiSanto is a shareholder with Bush Ross, PA in Tampa, Fla., and is the practice group leader of the firm's Bankruptcy Department. Luis Rivera is a shareholder with GrayRobinson, PA in Fort Myers, Fla., and is the deputy section chair of the firm's Bankruptcy Department and deputy managing shareholder of the Fort Myers and Naples, Fla., offices.

The Small Business Reorganization Act of 2019 (SBRA) took effect a little more than five years ago, creating subchapter V and introducing a series of entirely new Bankruptcy Code sections. The SBRA's enactment was uncontroversial; President Donald Trump signed the bill into law 66 days after it was introduced in the House.[2] It passed with broad bipartisan support, with congressional debate lasting only four minutes.[3]

However, over the past half-decade, bankruptcy courts and practitioners alike have grappled with new issues that have arisen while interpreting subchapter V and the required confirming amendments. Among the challenges has been sorting out the tension between the plain language of new Code sections and the potentially unintended consequences of piecemeal change and conforming amendments. Section 1192 of the Bankruptcy Code is one of those difficult provisions to reconcile.

Section 1192, which covers both individual and corporate subchapter V debtors, but only applies to nonconsensual plans confirmed under § 1191(b), provides that "the court shall grant the debtor a discharge of all debts provided in section 1141(d)(1)(A) ... except any debt ... of the kind specified in section 523(a) of this title."[4] This new Code section was coupled with a conforming amendment to § 523, which added § 1192 to the preamble of § 523 so that it read, "A discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not...."[5]

There was little discussion regarding adding § 1192 to the preamble of § 523. The addition was not mentioned in the official bill summary compiled by the Congressional Research Service.[6] The SBRA made dozens of similar conforming amendments to the Bankruptcy Code to accommodate the newly minted subchapter V.[7] However, the effect of this conforming amendment was that § 523(a) now provides that "[a] discharge under section 727, 1141, 1192, 1228(a), 1228(b), or 1328(b) of this title does not discharge *an individual debtor* from" 20 types of nondischargeable debts.[8] How can this apparent inconsistency be reconciled?

Granted, the interplay between §§ 1192 and 523 is awkward and clumsy, given § 523(a)'s preamble, which refers to "an individual debtor."[9] The first bankruptcy courts to address the applicability of § 523 to corporate subchapter V debtors almost uniformly concluded that corporate subchapter V debtors were not subject to § 523 and summarily dismissed creditors' adversary proceedings.[10] While these decisions focused on principles of statutory construction, these early courts' interpretations of §§ 1192 and 523 were later criticized by some as seemingly strained and likely influenced by policy and practical and equitable considerations rather than the plain language of the statutes.

The tides turned when bankruptcy and appellate courts engaged in a deeper analysis of the plain language of the statutes, and a new majority position gradually emerged. The Fourth Circuit was one of the first courts to conclude that § 523's discharge exceptions apply equally to corporate and individual debtors. The Fourth Circuit's holdings were later adopted by the Fifth Circuit in *GFS Industries*.[11] However, the debate rages on in bankruptcy courts across the nation, with one court swimming upstream against the weight of existing authority from the Fourth and Fifth Circuits.[12]

1 Ms. DiSanto is a subchapter V trustee, and Mr. Rivera is a chapter 7 trustee. They are both "40 Under 40" honorees (2023 and 2017, respectively).
2 *In re Progressive Solutions Inc.*, 615 B.R. 894, 896 (Bankr. C.D. Cal. 2020).
3 *Id.*; Small Business Reorganization Act of 2019, P.L. 116-54 (Aug. 23, 2019), 133 Stat. 1079.
4 11 U.S.C. § 1192.
5 H.R. 3311, 116th Cong. § 4(a)(5)-(12) (1st Sess. 2019).
6 H.R. 3311, Small Business Reorganization Act of 2019, congress.gov/bill/116th-congress/house-bill/3311 (last visited on Feb. 25, 2025).
7 H.R. 3311, 116th Cong. § 4(a)(5)-(12) (1st Sess. 2019).
8 11 U.S.C. § 523(a) (emphasis supplied).
9 *Matter of GFS Indus. LLC*, 99 F.4th 223, 226, 228 (5th Cir. 2024) ("[T]he question is complicated by a certain textual awkwardness in the Bankruptcy Code.").
10 *Lafferty v. Off-Spec Solutions LLC (In re Off-Spec Solutions LLC)*, 651 B.R. 862 (B.A.P. 9th Cir. 2023); *In re 2 Monkey Trading LLC*, 650 B.R. 521 (Bankr. M.D. Fla. 2023), *motion to certify appeal granted*, No. 6:22-BK-04099-TPG, 2023 WL 3947494 (Bankr. M.D. Fla. June 12, 2023); *In re Hall*, 651 B.R. 62 (Bankr. M.D. Fla. 2023); *In re Lapeer Aviation Inc.*, No. 21-31500-JDA, 2022 WL 1110072 (Bankr. E.D. Mich. April 13, 2022); *In re Rtech Fabrications LLC*, 635 B.R. 559, 568 (Bankr. D. Idaho 2021); *In re Cleary Packaging LLC*, 630 B.R. 466, 468 (Bankr. D. Md. 2021), *rev'd and remanded sub nom., In re Cleary Packaging LLC*, 36 F.4th 509 (4th Cir. 2022); *In re Satellite Rests. Inc. Crabcake Factory USA*, 626 B.R. 871 (Bankr. D. Md. 2021).
11 *Cleary Packaging LLC*, 36 F.4th 509.
12 *Spring v. Davidson (In re Davidson)*, Adv. Proc. No. 23-3005-JCO, 2025 WL 511226 (Bankr. N.D. Fla. Feb. 14, 2025); *Halo Human Res. LLC v. Am. Dental of LaGrange LLC (In re Am. Dental of LaGrange LLC)*, Adv. Proc. No. 24-01004-RMM, 2025 WL 384536, at *8 (Bankr. M.D. Ga. Feb. 3, 2025) (court declined to enter fray as to whether § 523 applies to corporate subchapter V debtors because case was confirmed consensually under § 1191(a); therefore, court did not need to reach issue).

In reconciling the tension between § 523(a)'s specific reference to individual debtors with the silence of § 1192, which applies to both individual and corporate debtors, the Fourth Circuit relied on the statutory interpretation principle of *lex specialis*, meaning that the more specific provision controls over the general.[13] The Fourth Circuit explained that § 1192's reference to the "kind[s] of debt specified in section 523(a)" is "a shorthand to avoid listing all 21 types of debts" enumerated in § 523.[14]

For better or worse, given principles of separation of powers, the judiciary's duty is to interpret the plain meaning of unambiguous statutes — even if that analysis results in unintended consequences. In the case of unambiguous laws, judges do not reach policy considerations or arguments. Perhaps this is the best result, as opinions differ on whether — based on practicality and policy — § 523 should apply to corporate debtors.

On one hand, debtors may argue that the Fourth and Fifth Circuits' interpretations of §§ 523 and 1192 produce unintended — if not absurd — results. One of the SBRA's primary policy objectives was to streamline the reorganization process by relieving small business debtors from the absolute-priority rule and thereby reducing the administrative costs of the case. Debtors argue that subjecting corporate subchapter V debtors to § 523 flies in the face of that goal.[15]

Objections to the dischargeability of debts are costly to litigate and involve fact-intensive factual disputes. Thus, a corporate subchapter V debtor might face an even greater and more expensive burden than the absolute-priority rule if forced to defend dischargeability actions under § 523.

Debtors may also argue that applying § 523 to corporate debtors in a subchapter V case will allow the unreasonable creditor to hijack the entire reorganization to the detriment of other creditors and interested parties. Regardless of the size of its claim or whether it controls the vote of a class of claims under the plan, any creditor could functionally bring the reorganization to a screeching halt by objecting to the dischargeability of its debt.

No matter how hard the debtor tries, the creditor landscape in many subchapter V cases often makes it impossible to avoid this roadblock by arriving at a consensual confirmation. The U.S. Small Business Administration (SBA) and merchant cash advance loans are often creditors in subchapter V cases. Regardless of the treatment of the SBA's claim, however favorable, it is often impossible for a debtor to obtain the SBA's acceptance of the plan. Likewise, merchant cash advance lenders seldom participate in the bankruptcy process, given the dubious and sometimes predatory nature of their dealings with the debtor. In short, applying § 523 to a corporate debtor allows an indignant creditor to capitalize on the inaction of others and entirely thwart the reorganization effort.

Debtors also argue that applying § 523 to corporate subchapter V debtors presents temporal procedural issues. Rule 4007 of the Federal Rules of Bankruptcy Procedure fixes the time for filing a complaint objecting to discharge under § 523(a)(2), (a)(4) and (a)(6) as 60 days after the first date set for the § 341 meeting of creditors — before the debtor may know whether the plan will be confirmed consensually or nonconsensually, and whether § 1192 governs the discharge.

Presumably, a bankruptcy court might abate a preconfirmation nondischargeability complaint until it is determined whether the debtor is able to confirm a plan consensually to avoid additional and unnecessary administrative expenses. However, extending the time for filing dischargeability complaints is not a solution, because a debtor will want to know before confirmation whether it will face litigation over the dischargeability of a debt so that the costs of litigation can be factored into the debtor's projected disposable-income calculations. Another wrinkle is this: Can a debtor withdraw the subchapter V election if a nondischargeability complaint is filed and proceed under traditional chapter 11 when the debtor has an impaired accepting class and can overcome the absolute-priority rule?

Creditors, on the other hand, might argue that subchapter V affords debtors significant advantages, and that applying § 523's exceptions to discharge to corporate debtors was a fair trade. For example, only the debtor may propose a plan, plans may be confirmed nonconsensually without the acceptance of any creditors, and the absolute-priority rule does not apply. Is it fair for the individual responsible for the acts or conduct giving rise to a dischargeability complaint to retain his or her interest in the debtor without paying the claim of the aggrieved creditor in full? Perhaps, as acknowledged by the Fifth Circuit in *GFS Industries*,[16] applying § 523 to corporate debtors strikes a balance between the rights of debtors and creditors in subchapter V, while also incentivizing debtors to pursue a consensual plan consistent with the policy goals and objectives of the subchapter V process.

Creditors might also argue that they have wielded their right to object to dischargeability judiciously. Since the SBRA's enactment, only a small number of adversary proceedings to determine the dischargeability of debt under § 523 have been initiated against corporate subchapter V debtors. The Middle District of Florida leads the U.S. in subchapter V filings with more than 1,000 cases to date, yet adversary proceedings initiated against corporate subchapter V debtors in that district have led to only two published decisions on the issue.

Finally, while there is scant legislative history on the addition of § 1192 to the preamble of § 523, creditors often note the fact that the SBRA's drafters modeled subchapter V after chapter 12 in many instances.[17] For 30 years, courts have interpreted nearly identical language to apply § 523 to corporate chapter 12 debtors.[18] In addition, the "Notice of Chapter 11 Bankruptcy Case for Corporations or Partnerships under Subchapter V" (Official Bankruptcy Form 309F) and the "Official Plan of Reorganization for Small Business

13 *Cleary Packaging LLC*, 36 F.4th 515.

14 *Id.*

15 H.R. Rep. No. 116-171, 1 (2019) (SBRA's purpose is to "streamline the bankruptcy process by which small business debtors reorganize and rehabilitate their financial affairs").

16 *GFS Indus. LLC*, 99 F.4th at 232. In rejecting the debtor's arguments, the Fifth Circuit explained that the debtor "misunderstands the compromises [that] Congress made in Subchapter V" and attempts to "rewrite that compromise."

17 *See* William L. Norton III, 2021 No. 6 *Norton Bankr. L. Adviser NL* 1 ("It appears that Subchapter V was drafted with the intention to apply dischargeability exceptions under … § 523 to corporations.").

18 *Sw. Georgia Farm Credit v. Breezy Ridge Farms Inc. (In re Breezy Ridge Farms Inc.)*, Adv. No. 08-12038-JDW, 2009 WL 1514671 (Bankr. M.D. Ga. May 29, 2009); *New Venture P'Ship v. JRB Consol. Inc. (In re JRB Consol. Inc.)*, 188 B.R. 373 (Bankr. W.D. Tex. 1995).

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Under Chapter 11" (Official Bankruptcy Form 425A) both contemplate that § 523's exceptions to discharge apply to corporations and partnerships. Most commentators also embrace the application of § 523 to non-individual debtors in the context of subchapter V.[19]

Alas, insolvency practitioners may never enjoy the satisfaction of knowing whether applying § 523 of the Bankruptcy Code to corporate debtors was Congress's informed policy decision or merely a drafting error. Perhaps the answer is immaterial, given the statute's plain language and the consistent interpretation to date by the circuit courts of appeals. A predictable system that allows for strategic and deliberate decision-making benefits debtors and creditors alike.

Even so, as courts try to harmonize the strained interplay between §§ 1192 and 523, Congress should either re-evaluate the policy considerations behind subjecting corporate subchapter V debtors to nondischargeability litigation, or more clearly articulate the policy objectives of balancing the interests of debtors and creditors. One suggestion might be for Congress to amend § 1192 to exclude from the exception to discharge those kinds of debts that are most hotly contested and less suited to corporate debtors: claims that a debt results from fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny (§ 523(a)(4)); and claims that a debt results from willful and malicious injury by the debtor to another (§ 523(a)(6)). Generally, these kinds of claims are least suited to corporate debtors because of the *mens rea* requirement,[20] yet they can easily derail a case to the detriment of both debtors and creditors alike.

One might also argue that claims that a debt was obtained by false pretenses, a false representation or actual fraud (§ 523(a)(2)) should also be excluded from § 1192's exception to discharge given the potential for meritless fraud claims.[21] Wherever the line is drawn, a narrowing of § 1192's exceptions to discharge would balance Congress's primary policy objective of streamlining the reorganization process for small businesses while maintaining a balance between the rights of debtors and creditors in subchapter V. abi

Editor's Note: *ABI's Subchapter V Task Force's Final Report and recommendations to Congress is posted at subvtaskforce.abi.org. All members are invited to submit their experiences with subchapter V at abi.org/subvstories.*

19 *See* William L Norton III, 2021 No. 6 *Norton Bankr. L. Adviser NL* 1; William L. Norton III & James B. Bailey, "The Pros and Cons of the Small Business Reorganization Act of 2019," 36 *Emory Bankr. Dev. J.* 383, 386 (2020); I.R.M. 5.9.8.5.1; *but see* Hon. Paul W. Bonapfel, *Guide to the Small Business Reorganization Act of 2019.*

20 *See, e.g., Matter of Berkemeier*, 51 B.R. 5, 6 (Bankr. S.D. Ind. 1983) (noting that embezzlement is act committed by individual).

21 *See* H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 365 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5787 (noting potential for creditors to initiate "false financial statement exception to discharge actions [under § 523(a)(2)] in the hopes of obtaining a settlement from an honest debtor anxious to save attorney's fees. Such practices impair the debtor's fresh start").