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Chapter 13: Its Operation, Its Statutory Requirements as to Payment to and Classification of Unsecured Claims, and Its Advantages

by: David G. Epstein*

In 1973, Sidney Rutberg, then Financial Editor of Fairchild Publications, wrote:

Some bankruptcy experts think Chapter XIII is just plain dumb, and in New York, where you find the most sophisticated bankruptcy people, you see very few of XIII's. Why beat your brains out to pay off a lot of debts if you can get your debts expunged forever by getting a discharge in bankruptcy?

In certain areas of the country, notably in the South and parts of New England, Chapter XIII is very popular. Part of this popularity stems from the pride of individuals who want to pay off every cent they owe and part is the result of local pressures. Threats of a creditless existence for all eternity could turn a prospective bankrupt into the loving arms of Chapter XIII.

Currently, filings of Chapter XIII petitions are running at about 30,000 a year and account for 15 percent of all bankruptcies filed. It is a proceeding based on the Puritan ethic and highly regarded by square America. If you like Lawrence Welk, you'll love Chapter XIII.¹

In 1980, some bankruptcy experts believe using anything other than Chapter 13 is dumb² and a debtor will love Chapter 13, even if he or she prefers the Village People or the Nitty Gritty Dirt Band to the Champagne Music Makers.

This article will explore the operation of Chapter 13, the two major legal questions raised by the present Chapter 13, and the advantages of Chapter 13 over Chapter 7 and 11.³

I. HOW CHAPTER 13 OPERATES

A. *Commencement Of The Case*

Chapter 13 of the Bankruptcy Reform Act of 1978 replaces Chapter XIII of the Bankruptcy Act of 1898. Chapter XIII was limited to a "wage earner,"⁴ *i.e.*, "an individual whose principal income is derived

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1. S. RUTBERG, TEN CENTS ON THE DOLLAR 125-26 (1973).

2. *See, e.g.*, DiPetro, *Chapter 13-Unlucky Number For The Uninformed Lawyer*, 53 CONN. B.J. 176 (1979); Kaplan, *Chapter 13 of The Bankruptcy Reform Act of 1978: An Attractive Alternative*, 28 DE PAUL L. REV. 1045 (1979).

3. For a more complete consideration of Chapter 13, *see* W. PHILLIPS, ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH A REGULAR INCOME (1979); Biery, *Debt Adjustment Under Chapter 13 of the Bankruptcy Reform Act of 1978*, 11 ST. MARY'S L.J. 473 (1979).

4. *See* Bankruptcy Act of 1898, § 606(3) (repealed 1978, previously codified at 11 U.S.C. § 1006(3)).

from wages, salary or commissions.”⁵

Chapter 13 is open to more debtors. Subject to limited exceptions, the source of income is not an eligibility test. Chapter 13 is available to self-employed businessmen and women⁶ and to welfare recipients.⁷ Section 109(e) governs Chapter 13 eligibility. A debtor may file for Chapter 13 relief if he or she:

1. is an individual,⁸ and
2. has a “regular income,”⁹ and
3. has fixed¹⁰ unsecured debts of less than \$100,000, and
4. has fixed secured debts of less than \$350,000.¹¹

Chapter 13, like Chapter 7 and Chapter 11, commences proceedings with the filing of a bankruptcy petition.¹² Chapter 13 is different from Chapter 7 and Chapter 11 since only the debtor may file a Chapter 13 petition. There are no involuntary, creditor-initiated, Chapter 13 proceedings.

The filing of a Chapter 13 petition triggers the automatic stay of section 362.¹³ Section 362 enjoins all formal and informal creditor collection efforts directed at the debtor or the debtor’s property. A Chapter 13 petition also stays collection activities directed against codebtors of the individual who filed the petition.

B. Codebtor Stay

Section 1301 restrains a creditor from attempting to collect a debt from the codebtor of a Chapter 13 debtor.

The following hypothetical illustrates the application of a codebtor stay under section 1301: J.R. borrows money from a financial institution to take a Dale Carnegie course. His mother, Miss Ellie, signs the note as comaker. J.R. later incurs financial problems and files a Chap-

5. Bankruptcy Act of 1898, § 606(8) (repealed 1978, previously codified at 11 U.S.C. § 1006(8)).

6. *E.g.*, *In re Sutherland*, 6 BANKR. CT. DEC. 13 (W.D. Ark. 1980); *In re Eaton*, 1 Bankr. Rep. 433 (M.D.N.C. 1979).

7. *E.g.*, *In re Beaver*, 2 Bankr. Rep. 337 (S.D. Cal. 1980); *In re Iacovoni*, 1 COLLIER BANKR. CAS. 331 (D. Utah 1980).

8. The term “individual” is not statutorily defined. Section 101(30) defines a “person” as including “individual, partnership, and corporation.” 11 U.S.C. § 101(30) (1978). This indicates that neither a partnership nor a corporation is an “individual.”

9. The phrase “individual with regular income” is defined in § 101(24) as an “individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title, other than a stock broker or a commodity broker.” 11 U.S.C. § 101(24) (1978). Does “a” plan refer to any Chapter 13 plan or the particular Chapter 13 proposed by this debtor? *In re Terry*, 1 COLLIER BANKR. CAS. 2d 525 (W.D. Ark. 1980), takes the position § 101(24) merely requires the debtor have the ability to make payments under the plan he or she proposes. Under *Terry*, if the debtor proposes a plan calling for minimal payments to creditors, minimal regular income is required. *Id.* at 527.

10. The debt limitation does not include contingent, unliquidated debts.

11. *Cf.* 11 U.S.C. § 506 (1978) (definition of secured claim).

12. 11 U.S.C. § 301 (1978).

13. See generally Kennedy, *Automatic Stays Under The New Bankruptcy Law*, 12 U. MICH. J.L. REF. 1 (1978).

ter 13 petition. Section 362 stays the financing institution from attempting to collect from J.R.; section 1301 stays attempts to collect from Miss Ellie.

Section 1301's stay of collection activities directed at codebtors is applicable only if the debt is a consumer debt and the codebtor is not in the credit business. This codebtor stay terminates automatically when the case is closed, dismissed or converted to Chapter 7 or 11.

Section 1301(c) provides three grounds for relief from the codebtor stay. It also requires notice and hearing¹⁴ and requires the court to grant relief if any of the three grounds are established.

First, the stay on collection from the codebtor will be lifted if the codebtor, not the Chapter 13 debtor, received the consideration for the claim.¹⁵ For example, if in the above hypothetical, Miss Ellie, and not J.R., filed for Chapter 13 relief, the financing institution could petition for the relief under section 1301(c)(1) in an attempt to collect from J.R. Section 1301(c)(1) also covers the situation in which the Chapter 13 debtor is merely an accommodation endorser.

Second, when the Chapter 13 plan has been filed, a creditor may obtain relief from the codebtor stay to the extent "the plan filed by the debtor proposes not to pay such claim."¹⁶ Assume, for example, that J.R. still owes \$200. J.R. proposes to pay each holder of an unsecured claim 70 cents on the dollar. As soon as this plan is filed, the financing institution can obtain relief from the codebtor stay to attempt to collect \$60 from Miss Ellie.

Third, section 1301(c)(3) requires the court to grant relief from the codebtor stay to the extent "such creditor's interest would be irreparably harmed by such stay."¹⁷ The running of a state statute of limitations is not a basis for relief under section 1301(c)(3). Section 108(c) guarantees the creditor at least 30 days after termination of the stay to file a state collection action against the codebtor.

C. Trustees

A trustee will be appointed in every Chapter 13 case.¹⁸ In many districts, the bankruptcy judge appoints a standing trustee who serves as trustee in every Chapter 13 case.¹⁹ In a number of pilot districts, Chapter 13 trustees are appointed by the United States trustee.²⁰ In a "United States trustee" district, the United States trustee appoints the

14. For a definition of "notice and hearing," see 11 U.S.C. § 102 (1978).

15. 11 U.S.C. § 1301(c)(1) (1978).

16. *Id.* at (c)(2).

17. *Id.* at (c)(3).

18. 11 U.S.C. § 1302(a) (1978).

19. 11 U.S.C. § 1302(d) (1978).

20. 11 U.S.C. § 1501 (1978). Kansas is in such a district. *Id.*

standing trustee.²¹ In these districts, the United States trustee serves in Chapter 13 cases if there is no standing trustee.

The trustee in Chapter 13 is an active trustee with all the avoidance powers of a bankruptcy trustee.²² Section 1302 also imposes a number of duties on the Chapter 13 trustee. Operation of the business is not one of the enumerated duties. If a debtor engaged in business files a Chapter 13 petition, section 1304(b) contemplates operation of the business by the debtor, not by the trustee, "[u]nless the court orders otherwise."²³

What is the meaning of the quoted phrase? Does it empower the court to appoint a trustee or does it merely allow the court to order the end of business operations? Collier takes the position the court may appoint a trustee to operate the Chapter 13 debtor's business.²⁴ This reading of section 1304 is questionable. Section 1302, which details the duties and powers of a Chapter 13 trustee, contains no language authorizing the trustee to operate the debtor's business. Moreover, section 1108 expressly authorizes the trustee to operate the debtor's business in a proceeding under Chapter 11. There is no counterpart to section 1108 in Chapter 13.

D. *Preparation Of The Chapter 13 Plan*

Only a debtor may file a Chapter 13 plan. The court may dismiss a Chapter 13 proceeding or convert it to Chapter 7 for "failure to file a plan timely under section 1321 of this title."²⁵ The Act leaves to the rules the question of the meaning of "timely"; that is, how many days the debtor has to file such a plan.

The Advisory Committee on Bankruptcy Rules is currently working on new Bankruptcy Rules. Section 405(d) of the Bankruptcy Code provides until these new Rules are promulgated, existing Bankruptcy Rules apply "to the extent not inconsistent with the Amendments made by this Act [the Bankruptcy Reform Act of 1978], or with this Act."²⁶ Rule 13-201 requires plans to be filed within ten days of filing the Chapter 13 petition.²⁷

Section 1322 governs the contents of a Chapter 13 plan. Subsection (a) of section 1322 specifies what the plan must provide; subsection (b) specifies what the plan may provide. A Chapter 13 plan must pro-

21. 11 U.S.C. § 151302 (1978).

22. For a general discussion of the avoidance powers of a bankruptcy trustee, see Aaron, *The Bankruptcy Reform Act of 1978: The Full-Employment-for-Lawyers Bill, Part IV: Avoiding Powers of the Trustee*, 1980 UTAH. L. REV. 19.

23. 11 U.S.C. § 1304(b) (1978).

24. 5 COLLIER ON BANKRUPTCY ¶ 1304.01, at 1304-4 (15th ed. 1979).

25. 11 U.S.C. § 1307(c)(3) (1978).

26. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 405(d), 92 Stat. 2549 (1978).

27. BANKR. PROC. R. 13-201, 11 U.S.C.A. (1977).

vide for full cash payment of all claims entitled to priority under section 507 unless the holder of the claim otherwise agrees. For example, most tax claims are entitled to priority under section 507. If *D* owes \$10,000 in 1979 taxes and files a Chapter 13 petition in 1980, she cannot escape her tax liability. Her plan must provide for full payment of the \$10,000 tax claim. The plan may, however, provide for installment payment of the \$10,000 tax debt over the period of the Chapter 13 plan.

A Chapter 13 plan may provide for less than full payment to other unsecured claims. The plan may pay some holders of unsecured claims more than others. It may either treat all unsecured claims the same or classify claims and provide for the same treatment of each unsecured claim within a particular class.²⁸

A Chapter 13 plan may also modify the rights of most holders of secured claims. It may alter the rights of Creditor *A* who has a security interest on the Chapter 13 debtor's car or Creditor *B* who has a mortgage on the Chapter 13 debtor's store. It may not, however, modify the rights of Creditor *C* who has a mortgage *only* on the Chapter 13 debtor's principal residence.²⁹

In the typical Chapter 13 proceeding, the source of the payments proposed by the plan will be the debtor's wages. This is not, however, a statutory requirement. Section 1322(a)(1) only requires the plan provide for submission of "such portion of future earnings . . . of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan." Payments under the plan may also be funded by sale of "property of the estate or property of the debtor."³⁰

Section 1322(c) limits the payment period under a Chapter 13 plan to three years, but payment periods as long as five years are permitted with court approval.

E. Confirmation Of The Chapter 13 Plan

In Chapter 13, creditors do not vote on the plan. Chapter 13 requires only court approval. The standards for judicial confirmation of a Chapter 13 plan are set out in section 1325.

Section 1325(a)(1) requires the plan satisfy Chapter 13 provisions and other applicable bankruptcy law requirements. Section 1325(a)(2) conditions confirmation on payment of the \$60 filing fee. Section 1325(a)(3) sets out a "good faith" standard. Section 1325(a)(4) protects

28. Questions concerning the statutorily required amounts to be paid holders of general claims and the classification of claims will be treated in Part II.

29. What if *C* has additional security for its claim? Under § 506, the right of setoff is equated with a secured claim. 11 U.S.C. § 506 (1978). It would thus seem if *D* obtained his house mortgage from *C* Savings and Loan and *D* maintains a savings account at *C* Savings and Loan, § 1322(b)(2) would not protect *C* Savings and Loan. See 11 U.S.C. § 1322(b)(2) (1978).

30. 11 U.S.C. § 1322(b)(8) (1978).

the holders of unsecured claims by imposing a "best interests of creditors" test: the present value of the proposed payments to a holder of an unsecured claim must at least equal the amount the creditor would have received in a Chapter 7 liquidation.

The following hypothetical situation illustrates the practical significance of the "present value" language in section 1325(a)(4). Assume Debtor owes \$10,000 and files a Chapter 13 petition. Had Debtor filed a Chapter 7 petition, the sale of the property of the estate would have yielded a sufficient sum to pay all priority creditors in full and pay general creditors 36 cents on the dollar. Debtor's Chapter 13 petition proposes to pay general creditors \$100 a month for 36 months. This plan does not satisfy the requirement of section 1325(a)(4). Payment of \$3,600 over a thirty-six month period does not have a "present value" of \$3,600.

Section 1325(a)(5) protects the holders of secured claims "provided for by the plan" by requiring one of the following:

- (A) Acceptance of the plan by such a creditor; or
- (B) Continuation of the lien and proposed payments to such a creditor of a present value at least equal to the value of the collateral; or
- (C) Surrender of the collateral to the creditor.

The following hypothetical situation illustrates the application of section 1325(a)(5). Assume Eddie Haskell owes Chaste Manhattan Bank \$4,000 and the bank has a security interest in Haskell's 1978 Chrysler. Haskell files for relief under Chapter 13. If the bank is not willing to accept Haskell's Chapter 13 plan, it will be necessary to appraise Haskell's car. The payments to the bank under the plan must have a present value at least equal to the value of Haskell's car. Accordingly, if Haskell's car is valued at only \$1,800, the present value of the payments to the bank must be at least \$1,800. (Under these facts, the bank would also have an unsecured claim for \$2,200).

Section 1325(a)(6) requires a determination of ability to perform; the debtor must "be able to make all payments under the plan and to comply with the plan."³¹

A confirmed Chapter 13 plan is binding on the debtor and all of his creditors.³² Unless the plan or the order confirming the plan otherwise provides, the plan vests all of the "property of the estate" in the debtor free and clear of "any claim or interest of any creditor provided for by the plan."³³ On confirmation, the plan is put into effect with the debtor generally making the payments provided in the plan to a Chapter 13 trustee who acts as a disbursing agent.

31. 11 U.S.C. § 1325(a)(6) (1978).

32. 11 U.S.C. § 1327(a) (1978).

33. 11 U.S.C. § 1327(c) (1978).

F. Discharge

Under section 1328(a) the debtor receives a discharge after completion of payments provided in Chapter 13. A section 1328(a) discharge is not subject to all the exceptions in section 523. The only debts excepted from a section 1328(a) discharge are:

- (1) Allowed claims not provided by the plan,
- (2) Certain long-term obligations specifically provided for by the plan,³⁴ and
- (3) Claims for alimony and child support.

The bankruptcy court may grant a discharge in a Chapter 13 case even though the debtor has not completed payments required by the plan. Section 1328(b) empowers the bankruptcy court to grant a "hardship" discharge if:

- (1) The debtor's failure to complete the plan was due to circumstances for which he or she "should not justly be held accountable";³⁵ and
- (2) The value of the payments made under the plan to each creditor at least equals what the creditor would have received under Chapter 7;³⁶ and
- (3) Modification of the plan is not "practicable."³⁷

A section 1328(b) "hardship" discharge is not as comprehensive as a section 1328(a) discharge. A "hardship" discharge is limited by all the section 523(a) exceptions to discharge and only relieves the debtor from personal liability on unsecured claims.³⁸

If a debtor receives a discharge under either section 1328(a) or section 1328(b), he or she may not receive a discharge in a Chapter 7 case filed within six years after the date the Chapter 13 case was filed unless payments under the Chapter 13 plan totalled at least 70% of the allowed unsecured claims and the plan was the "debtor's best effort."³⁹ A discharge under section 1328(a) or section 1328(b) does not affect the debtor's right to future Chapter 13 relief.

G. Dismissal And Conversion

A debtor who files a Chapter 13 petition may change his or her mind. At any time the debtor may request the bankruptcy court to

34. A Chapter 13 plan may not provide for a payment period of more than five years. 11 U.S.C. § 1322(c) (1978). Most Chapter 13 plans propose payment periods of three years or less. Some of the debtor's debts may have a longer payment period. Assume *D* buys a new car on January 10, 1980. She obtains financing from a bank; the note provides for payments of \$100 a month for 60 months. On March 30, 1981, *D* files for Chapter 13 relief. Her plan provides for payments to Bank of \$100 a month for the 36 months of the plan. See 11 U.S.C. § 1322(b)(5). On completion of the plan, *D*'s obligation to the bank for the remaining payments is excepted from discharge. 11 U.S.C. § 1328(a)(1).

35. 11 U.S.C. § 1328(b)(1) (1978).

36. *Id.* at (b)(2).

37. *Id.* at (b)(3).

38. 11 U.S.C. § 1328(c) (1978).

39. 11 U.S.C. § 727(a)(9) (1978).

dismiss the case or convert it to a Chapter 7 case.⁴⁰

The bankruptcy court may also dismiss a Chapter 13 case or convert it to a case under Chapter 7 on request of a creditor. The statutory standard for such creditor-requested conversion or dismissal is "for cause." Section 1307(c) provides seven examples of "cause."⁴¹

Under section 1307(d) a bankruptcy court may convert from Chapter 13 to Chapter 11 before confirmation of the plan on request of a party in interest and after notice and hearing. Section 1307(e) protects farmers from creditor-requested conversions from Chapter 13 to Chapter 7 or Chapter 11.

II. LEGAL QUESTIONS RAISED BY CHAPTER 13

A. *Amount Of Payments To Holders Of General Claims*

In proceedings under Chapter XIII of the Bankruptcy Act of 1898, the question of how much the debtor was legally obligated to pay his or her general creditors rarely arose. Almost all plans filed under Chapter XIII provided full payment of all filed and allowed general claims.⁴²

One possible reason for the popularity of extension plans in Chapter XIII is the creditor approval requirement: section 652 of the Bankruptcy Act of 1898 requires approval of the Chapter XIII plan by a majority in number and amount of the general creditors who have claims proved and allowed. Some creditors would not approve a plan providing less than full payment.⁴³

The availability of future bankruptcy relief was another factor influencing debtors to file Chapter XIII extension plans. A debtor who made all payments under a Chapter XIII extension plan and received a section 660 discharge was not barred from further bankruptcy relief.⁴⁴

40. 11 U.S.C. § 1307 (1978).

41. "Cause," within the meaning of § 1307(c), includes the following:

- (1) unreasonable delay by the debtor that is prejudicial to creditors;
- (2) nonpayment of any fees and charges required under chapter 123 of title 28;
- (3) failure to file a plan timely under section 1321 of this title;
- (4) denial of confirmation of a plan under section 1325 of this title and denial of additional time for filing another plan or a modification of a plan;
- (5) material default by the debtor with respect to a term of a confirmed plan;
- (6) revocation of the order of confirmation under section 1330 of this title, and denial of confirmation of a modified plan under section 1329 of this title; and
- (7) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan.

11 U.S.C. § 1307(c)(1)-(7) (1978).

42. REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, PART I, H.R. DOC. NO. 137, 93d Cong., 1st Sess. 160 (1973).

43. The Commission's Report minimizes the impact of the requirement of creditor acceptance. "Chapter XIII . . . requires a plan to have been accepted by a majority in number and amount of all the creditors whose claims have been proved and allowed before the conclusion of the meeting of creditors held under the Chapter. The Commission is informed that it is unusual for more than a few creditors to qualify to vote by filing claims." *Id.* at 174.

44. *Perry v. Commerce Loan Co.*, 383 U.S. 392 (1966). See generally Countryman, *Chapter XIII Wage Earner's Plans: Past, Present and Future*, 18 CATH. U.L. REV. 275, 279-84 (1969).

In the event further financial difficulties were encountered, the debtor could file for straight bankruptcy or Chapter XIII relief and receive a discharge. Under the Bankruptcy Act of 1898, a debtor who received a section 660 discharge after completing payments under a composition plan was precluded from receiving another bankruptcy discharge for six years.⁴⁵

Chapter 13 of the new Bankruptcy Code does not present the same obstacles to composition plans. There is no statutory requirement of creditor approval of Chapter 13 plans. Also, the impact of a discharge in a Chapter 13 composition proceeding on the availability of future bankruptcy relief has been reduced significantly. Under the new Bankruptcy Code, a debtor can file for relief under Chapter 13, propose a composition plan, complete the plan, receive a section 1328(a) discharge and be immediately eligible for another Chapter 13 discharge.⁴⁶

There has been a number of reported cases involving Chapter 13 composition plans raising the question of how much a Chapter 13 debtor is legally obligated to pay his or her creditors. Section 1325(a)(4) requires the present value of the plan's proposed payment to general claim holders at least equal the amount to be paid on such claim if the estate of the debtor were liquidated under Chapter 7 of this title on such date. This statutory provision seemingly requires two separate calculations. First, the present value of the proposed payments must be calculated. As noted earlier, the present value of monthly payments of \$100 for 36 months is obviously less than \$3,600. (The exact present value of such payments is less obvious). Second, the amount the holder of the general claim would receive in a Chapter 7 proceeding is calculated. In Chapter 7, the net proceeds from liquidation of the "property of the estate" is distributed to holders of general claims. Such claimants do not, however, receive the net proceeds from the sale of all of the "property of the estate" because:

I. some "property of the estate" will be turned over to the debtor as "exempt property" under section 522;⁴⁷

II. some property of the estate will be transferred to third parties protected by section 548 after filing the Chapter 7 petition;⁴⁸

III. some property of the estate will be subject to liens valid in bankruptcy. Under section 724, encumbered property or the proceeds thereof must be first used to satisfy the holders of secured claims;

45. Countryman, *supra* note 44, at 279.

46. Arguably, a bankruptcy court could consider the debtor's bankruptcy history in deciding whether to dismiss the Chapter 13 proceeding under § 305 or confirm a plan under § 1323(a)(3).

47. See generally Hughes, *Code Exemptions: Far-Reaching Achievement*, 28 DE PAUL L. REV. 1025 (1979).

48. See generally D. EPSTEIN, *DEBTOR-CREDITOR LAW IN A NUTSHELL* 227-32 (2d ed. 1980).

IV. some property of the estate must be used to satisfy claims entitled to a priority under section 507.

As a result of sections 522, 548, 724 and 507, many situations exist in which the holders general claims would receive nothing in Chapter 7.⁴⁹ In such situations a Chapter 13 plan providing for no payment or nominal payment to holders of general claims would seem to meet the requirements of section 1325(a)(4). A number of reported cases so hold.⁵⁰

However, many of these cases also hold a Chapter 13 plan providing only nominal payment to holders of general claims does not meet the requirement of section 1325(a)(3). Section 1325(a)(3) provides "the plan has been proposed in good faith and not by any means forbidden by law."⁵¹

The phrase "good faith" is not defined in the Bankruptcy Code nor discussed in the legislative history accompanying the Code. Section 656 of the Bankruptcy Act of 1898 contains a similar requirement;⁵² however, no reported cases construe the requirement of "good faith" under section 656. There is case law construing the requirement of good faith in section 1325(a)(3).

*In re Keckler*⁵³ found the good faith requirement of section 1325(a)(3) satisfied even though the debtor proposed to pay her general creditors only 5% and used Chapter 13 to escape personal liability on a debt excepted from discharge in a Chapter 7 proceeding. Ms. Keckler had no nonexempt property and owed \$11,500 to various general creditors. \$9,363 of the \$11,500 was owed to a bank which employed Ms. Keckler until she embezzled that amount.⁵⁴

Keckler did not view as relevant to the good faith issue either the amount of payment to unsecured creditors or the existence of claims dischargeable in Chapter 13 but not dischargeable in a Chapter 7 case. *In re Terry* is in accord.⁵⁵ There are, however, cases to the contrary.

49. On April 23, 1980, a bankruptcy judge in Kansas issued an opinion that suggests a somewhat different approach to § 1325(a)(4). In *In re McMinn*, 1 COLLIER BANKR. CAS. 2d 1007 (D. Kan. 1980), Judge Pusateri looked to not only what a creditor would receive from the distribution of the § 541 property of the estate in a Chapter 7 proceeding but also to what the creditor with a claim excepted from discharge could recover from the debtor individually after a Chapter 7 proceeding had terminated. He refused to confirm a Chapter 13 plan that provided for a payment of \$440 to a creditor with a \$44,000 claim that would be excepted from discharge in Chapter 7.

50. *E.g.*, *In re Beaver*, 2 Bankr. Rep. 337 (S.D. Cal. 1980); *In re Marlow*, 1 COLLIER BANKR. CAS. 2d 705 (N.D. Ill. 1980).

51. 11 U.S.C. § 1325(a)(3) (1978).

52. "The Court shall confirm a plan if satisfied that . . . (4) the proposal and its acceptance are in good faith" Bankruptcy Act of 1898, § 656 (repealed 1978, previously codified at 11 U.S.C. § 1056).

53. [1980] BANKR. L. REP. (CCH) ¶ 67,367 (N.D. Ohio 1980).

54. 11 U.S.C. § 523(a)(4) (1978) excepts from discharge any debt "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." *Id.*

55. 1 COLLIER BANKR. CAS. 2d 525 (W.D. Ark. 1980). *See also In re Cloutier*, 1 COLLIER BANKR. CAS. 2d 909 (D. Colo. 1980).

In *In re Beaver*,⁵⁶ an unemployed cashier with two children, \$3,206 of debts, \$955 of exempt property and monthly unemployment compensation of \$580 filed for relief under Chapter 13, formulating a plan under which her creditors would receive 1% of their claims. The court found:

[T]he debtor is proposing a repayment to her creditors which amounts to as much as they would receive in a liquidation case It is also the best effort that could be expected of someone in Ms. Beaver's circumstances to undertake. On the other hand, the repayment to creditors is only one percent and cannot be held to constitute a meaningful attempt to repay or "adjust" the debts involved.⁵⁷

The court refused to confirm the plan as it was not offered in "good faith."

The *Beaver* opinion defines "good faith" as follows: "[A] proper Chapter 13 plan must be a meaningful attempt to come to terms with creditors. In this context the requirement of good faith is one meaning more than just simple honesty. Instead, it requires a fundamental fairness in dealing with one's creditors."⁵⁸

*In re Marlow*⁵⁹ has a similar holding and similar language defining "good faith" under section 1325(a)(3). The court sustained a section 1325(a)(3) objection to confirmation of a plan providing for payment of 1% to a general claim holder who made a loan based on a false financial statement. The court stated, "The element of good faith requires the debtor, at the very least, to make meaningful payments to holders of unsecured claims. Otherwise, a Chapter 13 case may be construed as nothing more, in substance, than a Chapter 7 case, but without the disadvantage of certain provisions applicable in Chapter 7 cases."⁶⁰

Other reported Chapter 13 cases refusing to confirm no payment or nominal payment plans use the phrase "meaningful payment." What is a "meaningful payment"? Is there any statutory basis for deciding what amount is "meaningful"? Is there any practical way of determining what amount is "meaningful"?

Two reported cases have addressed these questions. Dictum in *In re Curtis*⁶¹ establishes a "rule of thumb" for determining whether the payments proposed are in good faith: "in the absence of exceptional circumstances, a debtor demonstrates his good faith by proposing to pay at least 10% of his take-home pay over the three-year period ordi-

56. 2 Bankr. Rep. 337 (S.D. Cal. 1980).

57. *Id.* at 341 (footnote omitted).

58. *Id.* at 340.

59. 1 COLLIER BANKR. CAS. 2d 705 (N.D. Ill. 1980).

60. *Id.* at 708.

61. 2 Bankr. Rep. 43 (W.D. Mo. 1979).

narily allowed as the maximum duration for chapter 13 plans."⁶² The court in *Curtis* found exceptional circumstances and confirmed a plan providing payments of \$75 a month for 18 months.

The *Curtis* opinion does not discuss whether a statutory basis exists for its "ten per cent of take-home pay rule of thumb." *In re Burrell*⁶³ does discuss the statutory grounds for the 70% payment rule it established.

In re Burrell denied confirmation of a plan providing payment of fifteen cents on the dollar to each holder of an unsecured claim. The court found the plan "proposes to pay holders of unsecured claims 'not less than the amount that would be paid on such claims if the estate of the debtor were liquidated under Chapter 7'" and "represents the debtor's best effort."⁶⁴ Confirmation of the plan was nevertheless denied because "the proposed payment to unsecured creditors is not substantial; which means that at least 70% of the allowed unsecured claims would be paid."⁶⁵

The *Burrell* opinion expressly acknowledges the absence of statutory language requiring 70% payments in Chapter 13 plans and the fact it reads this requirement into section 1325. *Burrell* takes the position that the benefits of Chapter 13—no requirement of creditor approval, inapplicability of section 523 exceptions to discharge—are so great. Congress must have intended such benefits be available only to Chapter 13 debtors who make substantial payments to their creditors.

Burrell derives its 70% requirement from section 727(a)(9). That section sets out the effect of a discharge in a prior Chapter 13 proceeding on a discharge in a Chapter 7 case. If a debtor who has filed for relief under Chapter 7 received a discharge in an earlier Chapter 13 proceeding, he or she will be denied a discharge in the Chapter 7 proceeding unless the payments under the prior Chapter 13 plan totalled at least 70% of the allowed unsecured claims.

Section 727(a)(9) clearly contemplates that some Chapter 13 debtors will receive a discharge even though they paid general creditors less than 70% of their claim. *Burrell* clearly contemplates that all Chapter 13 plans will propose at least 70% payments. Under *Burrell*, section 727(a)(9)'s 70% requirement would be triggered only by the following specific fact situation: Debtor files a Chapter 13 petition and a Chapter 13 plan that proposes to pay Debtor's general creditors at least 70% of their claims. Debtor is unable to satisfy the obligations imposed by the plan but, nevertheless, receives a section 1328(b) "hardship" discharge.

62. *Id.* at 45. Cf. *In re Crockett*, [1980] BANKR. L. REP. (CCH) ¶ 67,406 (N.D. Ill. 1980) (confirming a Chapter 13 plan providing for 10% payment on general claims).

63. 2 Bankr. Rep. 650 (N.D. Cal. 1980).

64. *Id.* at 651.

65. *Id.*

Debtor later files a petition for relief under Chapter 7 of the Bankruptcy Code. Under *Burrell*, section 727(a)(9)'s 70% requirement would be surplusage as to debtors who completed payments under their Chapter 13 plans and received a section 1328(a) discharge.

This brief review of the cases imposing a "meaningful" or "substantial" payment requirement as a condition of confirmation of a Chapter 13 plan points up the two major problems with such judicial action. First, there is no statutory basis for such a requirement. Nothing in the new Bankruptcy Code directly states or even indirectly suggests a debtor must propose to make "meaningful" or "substantial" payments in his or her Chapter 13 plan. Indeed, section 1325(a)(4) seems to suggest the contrary. That subsection expressly deals with the question of how much a debtor must propose to pay his or her creditors in a Chapter 13 plan—not less than such creditors would receive in a Chapter 7 proceeding. Second, any attempt by a court to add a requirement of "meaningful" or "substantial" payments raises the obvious practical question of what amount is required. Why is 70% "substantial" when 69% payments would not be? Why are 10% payments adequate in Missouri but not in the Northern District of California?

It is easy for a law teacher to suggest to lawyers and law students that Chapter 13 permits a debtor in a "no asset" case to file a plan providing no payment or nominal payment on unsecured claims. It is not so easy for an attorney or a law student to suggest such action to a client. Professor Countryman recently pointed out a possible risk inherent in such action—no discharge. Chapter 13 discharge releases the debtor only from debts "provided for by the plan."⁶⁶ Is a debt "provided for by the plan" if the plan provides no payment or payment of 1% on the debt?⁶⁷

Professor Neustadler suggested a second risk of no payment or nominal payment plans—conversion to Chapter 7.⁶⁸

B. *Classification Of General Claims*

In proceedings under Chapter XIII of the Bankruptcy Act of 1898, questions of how the debtor classified his or her general creditors never arose. Section 646 required every Chapter XIII plan to include provisions "dealing with unsecured debts generally, upon any terms."⁶⁹ The word "generally" was read as requiring equal treatment of general

66. 11 U.S.C. § 1328(a) (1978).

67. Countryman, *Letter to the Editor*, 85 COM. L.J. 28 (1980).

68. Neustadler, *Consumer Insolvency Counseling for Californians in the 1980's*, 19 SANTA CLARA L. REV. 817, 912 (1979).

69. Bankruptcy Act of 1898, § 646(1) (repealed 1978, previously codified at 11 U.S.C. § 1046(1)).

claims and payment of the same percentage of the debt on all unsecured debts.⁷⁰ A Chapter XIII plan cannot classify unsecured claims and provide different treatment to different classes. A Chapter 13 plan can.

Section 1322(b)(1) expressly authorizes a debtor to classify unsecured claims in his or her Chapter 13 plan. This power to classify is subject to two statutory limitations.

First, section 1322(b)(1) expressly refers to section 1122: "designate a class or classes of unsecured claims, as *provided* in section 1122."⁷¹ Legislative history indicates any classification of claims in a Chapter 13 plan is "subject to" the provisions of section 1122.⁷²

Section 1122 provides:

(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

(b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.⁷³

Note that section 1122(a) merely requires every claim in a particular class be "substantially similar." It does not expressly require every "substantially similar" claim to be in the same class.⁷⁴ If some general claims are "Type A" and some general claims are "Type B," section 1129(a) prohibits putting both "Type A" claims and "Type B" claims in the same class. It does not, however, seem to require all "Type A" claims be placed in the same class.

From the language of section 1129(a), apparently even if all the debtor's unsecured debts were "substantially similar" he or she could still classify claims. However, from the language of section 1322(b), a Chapter 13 debtor with ten "substantially similar debts" seemingly *cannot* divide his or her debts into classes. The second limitation on a classification of claims in section 1322(b)(1) is that the plan may not "discriminate unfairly against any class so designated."

Every classification discriminates. Which classifications discriminate "unfairly"? The "discriminates unfairly" test is unique to Chapter 13 of the new Bankruptcy Code. There was no counterpart in the

70. See 10 COLLIER ON BANKRUPTCY ¶ 28.02, at 272-73 (14th ed. 1976).

71. 11 U.S.C. § 1322(b)(1) (emphasis added).

72. S. REP. NO. 989, 95th Cong., 2d Sess. 118, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5787; H.R. REP. NO. 595, 95th Cong., 1st Sess. 406, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 5963.

73. 11 U.S.C. § 1122 (1978).

74. See generally 5 COLLIER ON BANKRUPTCY, *supra* note 24, ¶ 1122.03, at 1122-4, cited with approval in *In re Gay*, 1 COLLIER BANKR. CAS. 2d 790, 791-92 (D. Colo. 1980).

Bankruptcy Act of 1898; there is no corresponding provision in Chapter 11 of the new Bankruptcy Code.

Judge Creahan of New York,⁷⁵ Judge Sidman of Ohio,⁷⁶ and Judge Mabey of Utah⁷⁷ have relied on the "discriminates unfairly" language to require all similar claims in a Chapter 13 plan be in the same class. For example, in *In re McKenzie*,⁷⁸ Judge Creahan refused to confirm a Chapter 13 plan providing full payment to holders of unsecured claims on which there was a codebtor and payment of 50% to all other holders of unsecured claims. In so ruling, Judge Creahan stated: "It is difficult to imagine any classification of unsecured creditors which would not discriminate against some class in one manner or another. Classification in itself would seem to denote discrimination. . . . Here, all unsecured creditors have the same rights vis-a-vis estate property"⁷⁹

If, as Judge Creahan suggests in *McKenzie*, all creditors having the same rights vis-à-vis estate property must be in the same class, all holders of general claims must be in the same class. Judge Lee of Kentucky made a somewhat similar suggestion in a recent law review article.

The Code permits unsecured debts to be placed in a separate class on the basis of amount in order that small claims may be paid expeditiously for administrative convenience. [(Section 1122(b))] It also permits unsecured claims on which the last payment is due after the date on which the final payment under the plan is due to be dealt with separately. [(Section 1322(b)(5))] There is no authorization for further classification of unsecured debts.⁸⁰

There are, however, reported cases authorizing "further classification of unsecured debts." *In re Curtis*,⁸¹ confirmed a Chapter 13 plan dividing unsecured claims into two classes: class #1 for child support payments and class #2 for all other unsecured claims. Under the plan, class #1 was to be paid 100% and class #2 was to be paid 10%. In formulating the plan, the debtor was obviously influenced by section 523(a)(5) which excepts child support claims from the operation of a discharge. In approving the plan, the bankruptcy court was similarly influenced:

[I]t appears that there is a rational basis for the discrimination between the two classes and that it must therefore be regarded as "fair" within the meaning of the above section. [section 1322(b)(1)] For the obvious import of the nondischargeability section is that child

75. *In re McKenzie*, 1 COLLIER BANKR. CAS. 2d 599 (W.D.N.Y. 1980).

76. *In re Blevins*, 1 Bankr. Rep. 442 (S.D. Ohio 1979); *In re Fizer*, 1 Bankr. Rep. 400 (S.D. Ohio 1979).

77. *In re Iacovoni*, 2 Bankr. Rep. 256, 260 (D. Utah 1980).

78. 1 COLLIER BANKR. CAS. 2d 599 (W.D.N.Y. 1980).

79. *Id.* at 603. See *In re Utter*, 1 COLLIER BANKR. CAS. 2d 930 (W.D.N.Y. 1980) (§ 1322(b)(1) prohibits the separate classification of codebtor claims); *In re Iacovoni*, 2 Bankr. Rep. 256 (D. Utah 1980) (same).

80. Lee, *Chapter 13 nee Chapter XIII*, 53 AM. BANKR. L.J. 303, 313 (1979).

81. 1 COLLIER BANKR. CAS. 2d 314 (W.D. Mo. 1979).

support payments are *generally* to be regarded as having a status higher than the ordinary indebtedness under the law of bankruptcy.⁸²

Notwithstanding that *Curtis* describes child support claims as “generally regarded as having a status higher than ordinary indebtedness under the law of bankruptcy,” a child support claimant has the “same rights vis-a-vis estate property” as other creditors. The holding in *Curtis* is inconsistent with the dictum in *McKenzie*.

The holding and the dictum in *In re Sutherland*⁸³ is consistent with *Curtis*. *In re Sutherland* confirmed a Chapter 13 plan with four classes of general claims:

- (1) medical bills;
- (2) bank credit;
- (3) accounts from creditors that debtor intends to continue doing business with; and
- (4) all creditors.

All of the claims had the “same rights vis-a-vis estate property.” While none of the claims were excepted from discharge, the classification was nevertheless approved.

Sutherland rejects a “rationality of the classification test” as improper judicial legislating. Instead,

The question under 11 U.S.C. § 1322(b)(1) is not “rationality” of the classifications. The question is whether there is “unfairness” between the classes. When a creditor or a class of creditors are not legally entitled to receive anything, they cannot be classified in an unfairly discriminatory manner. If a plan proposes to pay each unsecured claim at least as much as that claim would receive in liquidation under Chapter 7, the plan can propose to pay additional sums to a single unsecured creditor or classes of other unsecured creditors without unfairly discriminating. The debtors are paying more than is legally required and the Courts should not discourage such plans.

Under circumstances where the debtors do not have to pay anything to any unsecured creditors, it makes no sense to have a system that prevents them from paying one or more unsecured creditors of their choosing. Surely the Bankruptcy Courts should not be in a position of telling debtors that they cannot voluntarily pay a creditor from property or future income in which other creditors have no right.⁸⁴

The *Sutherland* opinion seems to be an example of judicial legislating. The court is not adding to legislation; it is in effect taking away from legislation. Under the language of *Sutherland*, any Chapter 13 plan meeting the requirement of section 1325(a)(4) also meets the re-

82. *Id.* at 316 (emphasis added).

83. 6 BANKR. CT. DEC. 13 (W.D. Ark. 1980).

84. *Id.* at 14. Note § 524 places bankruptcy courts in the position of telling debtors they cannot voluntarily make a binding obligation to pay a creditor from future property or from future income in which other creditors have no rights. See *In re Woodford*, 1 COLLIER BANKR. CAS. 2d 789 (M.D. Fla. 1980).

quirement of section 1322(b)(1).⁸⁵

As *Sutherland* illustrates, the resolution of the question of permissible classification of claims under section 1322(b)(1) is closely tied to the resolution of the question of the amount of payment legally required by section 1325(a)(4).⁸⁶ The question of classification of claims in Chapter 13 plans should not, however, be tied to the question of classification of claims in Chapter 11. The differences between Chapter 11 and Chapter 13 call for different policies on claim classification.⁸⁷

In Chapter 11, creditors vote on plans by classes. A plan cannot be confirmed unless at least one class of claims has accepted the plan.⁸⁸ This requirement of Chapter 11 could easily be circumvented if Chapter 11 debtors were given a free hand in classifying claims. Chapter 13 has no corresponding requirement, thus, classification in Chapter 13 does not present the same problem.

Classification of claims in Chapter 13 presents problems of interpreting cryptic statutory language and balancing competing policy considerations. The cases have identified the critical statutory language—"as provided in section 1122" and "discriminate unfairly," and the critical policy considerations—treating similar creditors similarly and encouraging the debtor to pay as much as possible to creditors.

III. ADVANTAGES OF CHAPTER 13

Regardless of the ultimate resolution of the legal issues discussed in Part II of this Article, Chapter 13 offers a number of advantages to the debtor seeking bankruptcy relief.

A debtor considering filing for relief under Chapter 7 who is eligible for Chapter 13 would realize the following benefits from filing under Chapter 13 instead of Chapter 7:

(1) a more comprehensive stay:

The automatic stay of section 362 protects both Chapter 7 debtors and Chapter 13 debtors from formal and informal collection efforts. In Chapter 13, section 1301 also protects codebtors. Chapter 7 has no corresponding protection.

(2) retention of property:

In Chapter 7, "property of the estate" as described in section 541 is distributed to creditors. In Chapter 13, the debtor keeps "property of

85. *Sutherland* involves a plan that proposed to pay certain classes of creditors more than others. Perhaps the court would find plans proposing to pay certain classes of creditors before others "discriminates unfairly." See 5 COLLIER ON BANKRUPTCY, *supra* note 24, ¶ 1322.01, at 1322-7.

86. See also *In re Iacovoni*, 2 Bankr. Rep. 256, 261 (D. Utah 1980).

87. For a general discussion of Chapter 11, see D. EPSTEIN, *supra* note 48, at 279-302.

88. 11 U.S.C. § 1129(a)(10) (1978).

the estate," except as provided in the plan or in the order of confirmation.

(3) availability of discharge:

A Chapter 7 will be barred from discharge if a party in interest establishes any of the ten objections to discharge listed in section 727. Section 727 does not apply in Chapter 13.

(4) debts discharged:

Section 523 excepts nine classes of claims from the operation of a bankruptcy discharge. All nine exceptions apply to a Chapter 7 debtor. Only the exception for alimony and child support applies to a debtor who has filed for relief under Chapter 13 and completed his or her obligations under the Chapter 13 plan.

(5) effect on future Chapter 7 relief:

A debtor who receives a Chapter 7 discharge may not obtain a discharge in another Chapter 7 case for six years. A Chapter 13 discharge does not affect the availability of future Chapter 7 relief if the Chapter 13 plan was the debtor's best effort and paid at least 70% of the general claims. Neither a Chapter 7 discharge nor a Chapter 13 discharge affects the availability of future Chapter 13 relief.

(6) tax relief:

Neither Chapter 7 nor Chapter 13 provides an escape from most tax liability. Chapter 13 does, however, provide greater relief. Since most tax claims are excepted from discharge, a debtor who has filed for Chapter 7 relief and received a discharge faces immediate liability for all unsatisfied tax claims. In Chapter 13, the debtor can spread out his tax payments over the life of the plan.

(7) cure defaults:

In his or her Chapter 13 plan, a debtor can provide for the curing of any defaults on secured or unsecured claims.⁸⁹ Assume, for example, that *D* makes house payments of \$360 a month. *D* misses two payments. *D* then files for relief under Chapter 13. *D*'s Chapter 13 plan can cure that default created by the two missed \$360 payments by providing in the plan for house payments of \$380 for the 36 months of the plan.

If *D* files instead under Chapter 7, *D* would not have 36 months to cure her default. Rather, the mortgagor could foreclose after the Chapter 7 proceeding was dismissed if *D* did not immediately make up the \$720 delinquency.

(8) discharge liens:

Section 722 empowers a Chapter 7 debtor to extinguish otherwise valid liens by paying the lienor the value of its collateral. *C* has a se-

89. 11 U.S.C. § 1322(b)(3), (5) (1978).

curity interest on *D's* 1978 Chrysler to secure its \$4,000. If the Chrysler is only worth \$1,800, *D* can extinguish *C's* lien by paying *C* \$1,800. Section 722 seems to contemplate cash payment.⁹⁰ As discussed above, a Chapter 13 debtor could discharge *C's* lien by making payments that have a present value of \$1,800 over the period of the Chapter 13 plan.⁹¹

A business debtor who is eligible for Chapter 13 should carefully consider Chapter 13 before filing a Chapter 11 petition. Chapter 13 has the following advantages over Chapter 11:

- (1) Codebtors are protected by Section 1301.
- (2) A debtor desiring to continue operating his or her business is less likely to be displaced in Chapter 13 than in Chapter 11.
- (3) Only the debtor may file a Chapter 13 plan.
- (4) Chapter 13 makes no provision for creditors' committees.
- (5) Chapter 13 does not require creditor acceptance of a plan of rehabilitation.

90. Section 524(c)(4) suggests that installment payments under § 722 require the creditor's agreement. 11 U.S.C. § 524(c)(4) (1978).

91. For a discussion of § 1325, see text and notes accompanying section E *supra*.