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AN OVERVIEW OF CHAPTER 13—ITS USES AND ABUSES

By Harold V. Dye*

I. INTRODUCTION

Recent economic conditions have brought far-reaching changes to the practice of debtor representation. Individuals who never considered taking bankruptcy have found themselves overextended and, perhaps pressured by major creditors, have sought legal counsel on how they could protect themselves.

Traditional legal thinking in many areas of the country, including Montana, was that there were only two solutions to such an individual's problem—an informal, non-judicial "work-out" and straight bankruptcy. Notably ignored, most probably out of the attorney's lack of knowledge, was use of a Chapter XIII, renamed Chapter 13 in the 1978 Act, repayment plan. Yet, in many cases, Chapter 13 represents the best possible solution to the middle-class debtor's problem. A well-designed Chapter 13 plan can give the debtor a fresh start, preserve many assets and salvage much of a credit rating as well. At the same time, unlike a non-judicial work-out, Chapter 13 does not depend upon creditor cooperation for its successful implementation. Thus, the twin obstacles to successful non-judicial debtor rehabilitation—excessive squeezing by creditors and intercreditor jockeying for better position—are eliminated. In addition, the unique features of Chapter 13, including more extensive discharge and the ability to cure defaults, reject burdensome executory contracts and redeem secured collateral over time, combine to make it the vehicle of choice in dealing with a middle-class debtor's financial problems.¹

This article will explore the procedure used in Chapter 13 cases and show how it may be used in the client's best advantage. It is written primarily from the perspective of a debtor's attorney. The areas of potential abuse of Chapter 13 will be touched on for the benefit of creditors' counsel.

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¹ Obviously, a non-judicial work-out is the best solution to a debtor's financial problems if practicable. However, by the time many debtors consult counsel, most have tried and failed at solving financial problems by non-judicial means.
A. Background—History of Former Chapter XIII

Chapter XIII was originally enacted as part of the mid-depression reform of the bankruptcy laws in 1938. Its purpose, according to its sponsor, was to protect "persons who are employed for wages or salaries and who, without being adjudicated bankrupt, wish to pay their debts under the protection of a federal court, free from garnishments, executions, attachments, penalties, usury or excessive costs." 3

When Chapter XIII was enacted, section 74 of the Bankruptcy Act authorizing compositions was in force as were many state composition statutes. Chapter XIII was enacted as a "small claims" procedure directed specifically at debt relief for the wage earner. Indeed, originally, Chapter XIII was not only limited to persons whose "principal income is derived from wages, salaries or commissions," but was further limited to persons whose total income did "not exceed $3,600 per year." 5 Later the income limitations were removed but Chapter XIII remained limited to employees.

The success of Chapter XIII varied widely from district to district. 4 This was in large part due to differing attitudes on the part of judges, trustees and practitioners as to whether Chapter XIII was a workable debt adjustment device or merely a time-consuming prelude to straight bankruptcy. 7

B. The Bankruptcy Reform Act

The Bankruptcy Reform Act of 1978 8 made radical revisions to the former Chapter XIII, renamed Chapter 13. These changes were made with an express Congressional intent to encourage use of Chapter 13 as an alternative to straight bankruptcy. 9 The provisions of Chapter 13 were expanded, simplified and made more flex-

4. 11 U.S.C. § 1006(8) (1976) (Bankruptcy Act § 606(8)).
5. Chandler Act, supra note 2, at 931.
7. Id. at 176.
8. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (enacting Title 11, United States Code). This enactment will be referred to throughout this article as the "Bankruptcy Code" or the "Code." The Bankruptcy Act of 1898, as amended, will be the "Bankruptcy Act" or the "Act." The Act's wage earner adjustment provision was Chapter XIII while the Code's provisions for adjustment of debts of persons with regular income is Chapter 13. All section references in text and citation in footnotes are to 11 U.S.C. (Supp. III 1979) unless otherwise indicated.

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Many of the "provisions in the current bankruptcy law that enable private action to undo the beneficial effects of bankruptcy" were eliminated.\textsuperscript{10} While the essential concept of payment out of future income was retained, eligibility for relief under Chapter 13 was expanded from wage earners to any "individual with regular income." An individual with regular income is somewhat circuitously defined as an "individual whose income is sufficiently stable and regular to enable such individual to make planned payments under a plan under Chapter 13 of this title, other than a stock broker or a commodity broker."\textsuperscript{11} Eligibility for Chapter 13 is restricted to persons with less than $100,000 in non-contingent, liquidated, unsecured debts and $350,000 in non-contingent, liquidated, secured debts.\textsuperscript{12}

The use of composition plans—as opposed to extension plans—was encouraged by eliminating the requirement for unsecured creditors' consent to a plan\textsuperscript{13} and by requiring that a plan must be completed within three years.\textsuperscript{14} Congress also adopted numerous provisions to increase the use of Chapter 13 plans, including expanded dischargability vis-a-vis straight bankruptcy,\textsuperscript{15} protection of co-debtors,\textsuperscript{16} the ability to redeem secured collateral over time,\textsuperscript{17} and the ability to cure defaults.\textsuperscript{18}

Congress greatly enlarged the "carrot" of Chapter 13 by making it substantially more debtor-oriented, while Congress refrained from creating an involuntary Chapter 13. Chapter 13 remains as Chapter XIII was before it, an entirely voluntary proceeding.\textsuperscript{19} Only a debtor may file under Chapter 13,\textsuperscript{20} and a Chapter 7 (liquidation) or Chapter 11 (reorganization) proceeding may be con-

\textsuperscript{10} Id. at 117-18.
\textsuperscript{11} Id. at 117.
\textsuperscript{12} 11 U.S.C. § 101(24).
\textsuperscript{13} 11 U.S.C. § 109(e).
\textsuperscript{15} 11 U.S.C. § 1322(c). A court may "for cause" approve a plan lasting no longer than five years either as originally proposed or as modified. 11 U.S.C. §§ 1322(c), 1329(c). These limitations were imposed because of Congress' finding that excessively long repayment plans did not provide debtors with the relief and fresh start that are "the essence of modern bankruptcy law," and therefore, the plans were the closest thing in modern America to indentured servitude. House Report, supra note 9, at 117.
\textsuperscript{16} 11 U.S.C. § 1328(a).
\textsuperscript{17} 11 U.S.C. § 1301.
\textsuperscript{18} 11 U.S.C. § 1325(a)(5).
\textsuperscript{19} 11 U.S.C. § 1322(b)(5).
\textsuperscript{20} Congress was concerned that an involuntary Chapter 13 would violate the Thirteenth Amendment and be "debt peonage." House Report, supra note 9, at 120-21.
\textsuperscript{21} 11 U.S.C. § 303(a).
verted to Chapter 13 only with the consent of the debtor.\textsuperscript{22} The Chapter 13 debtor has the absolute right to convert to a Chapter 7 liquidation at any time,\textsuperscript{23} and only the debtor may propose a Chapter 13 plan.\textsuperscript{24}

II. Procedure Under Chapter 13

As with any voluntary bankruptcy matter, a Chapter 13 case is commenced by filing a petition with the bankruptcy court.\textsuperscript{25} Filing the petition constitutes an order for relief,\textsuperscript{26} imposes an automatic stay on any action against the debtor or the debtor's property,\textsuperscript{27} and invests the bankruptcy court with exclusive jurisdiction over this property.\textsuperscript{28} A statement of affairs should be filed with the petition, but on application the time may be extended.\textsuperscript{29} At present, the statement may be filed on Official Form 13-5 developed for use in Chapter XIII, supplemented by a statement of property claimed exempt\textsuperscript{30} and, in the case of a debtor engaged in business, by a statement of financial affairs.\textsuperscript{31}

A Chapter 13 plan must be filed with the petition or within 10 days thereafter.\textsuperscript{32} The court may grant an extension "for cause shown and on such notice to such persons as the court may direct."\textsuperscript{33} The plan may be filed on Official Form 13-6. Form 13-6, however, was developed for use under Chapter XIII and does not have a format for many of the provisions allowed by Chapter 13, such as classification of claims, curing of defaults, and modification of the rights of secured parties. Preparation of a custom-drafted plan, therefore, should always be considered. In complex cases,
CHAPTER 13 BANKRUPTCY

forms used in reorganization cases should be consulted.

Copies of the debtor’s plan are sent to creditors with a notice of first meeting of creditors. Under Bankruptcy Rule 13-202, a creditor must file a written rejection of a plan “prior to the conclusion of the first meeting of creditors” or the creditor is “deemed to have accepted such plan.” Rule 13-202 was developed under Chapter XIII, where the first meeting of creditors was combined with a hearing on confirmation of the plan presided over by the bankruptcy judge. It was necessary for the judge to know at the time of the hearing whether the requisite number of acceptances had been received so that the judge could decide whether the plan could be confirmed. The rule is somewhat anomalous under the Code, since now a first meeting of creditors is no more than an opportunity to examine the debtor, and because a separate confirmation hearing is held before the judge. Nevertheless, the rule is “not inconsistent with” the Code and, therefore, remains in effect. 34

Rule 13-202 is irrelevant to unsecured creditors since the Code no longer requires acceptance of unsecured creditors for confirmation of a plan. 35 The rule can be a trap, however, for the unwary secured creditor. The Code allows a Chapter 13 plan to modify the rights of secured creditors. 36 A secured creditor not timely rejecting a proposed plan may be deemed to have accepted the plan and be without standing to object to it at the confirmation hearing. Indeed, the creditor may not be able to challenge the debtor’s treatment of the creditor at all—as long as the debtor’s treatment is in conformity with the plan. This problem is compounded by the fact that the first meeting of creditors is usually held on short notice 37 and counsel usually does not become involved until later, when it may be too late. It is, therefore, prudent for creditors’ counsel to advise clients always to consult with counsel on any Chapter 13 plan as soon as it is received. Failing that, creditors’ counsel should advise universal rejection of Chapter 13 plans since that result can be more easily undone than the deemed acceptance of an unsatisfactory plan.

Following the first meeting of creditors, a confirmation hearing is held before the bankruptcy judge. 38 While the standards for confirmation will be discussed in more detail below, it should be noted

34. Bankruptcy Reform Act, supra note 8, § 405(d).
37. BANKRUPTCY RULE 13-203 requires a minimum of 10 days notice.
here that confirmation involves judgmental concepts such as “good faith” and questions of valuation, which must be decided by the judge on the basis of evidence presented. The hearing must therefore be regarded as an adversarial one by both creditor’s and debtor’s counsel. That is, a mere argument or objection will seldom prevail in the face of contrary evidence and, as in most litigation, the cause usually goes to the most prepared.

The importance of a Chapter 13 creditor actively protecting his rights is illustrated by the statutory effect of confirmation. Each creditor is bound by the provisions of a confirmed plan “whether or not the claim of such creditor is provided for by the plan,” and notwithstanding whether the creditor has rejected or objected to the plan. In addition, unless otherwise provided in the plan or the order of confirmation, confirmation “vests all the property of the estate in the debtor . . . free and clear of any claim or interest of any creditor provided for by the plan.”

This may be best illustrated by an example. Assume that a bank is owed $10,000 secured by the debtor’s four-wheel drive pickup, other vehicles, a collection of antique firearms and a collection of gold coins, which have a conservative wholesale market valuation of $30,000. The debtor proposes that the four-wheel drive pickup be surrendered to the bank in satisfaction of the debt and presents evidence at the confirmation hearing from a used car dealer that the four-wheel drive pickup is worth $10,000. Confirmation of the plan discharges the bank’s debt. It would also release the bank’s other security even though it turned out that, due to the depressed market for four-wheel drive vehicles, the bank only received $5,000 for the pickup.

A. The Role of the Trustee in Chapter 13 Cases

In revising Chapter 13, Congress superimposed a number of concepts from business reorganizations on the former structure of wage-earner’s plans. Like a Chapter 11 business reorganization, the Chapter 13 debtor remains in possession. However, unlike Chapter 11, a trustee is appointed in every Chapter 13 case. Unlike a

41. 11 U.S.C. § 1327(a).
42. 11 U.S.C. §§ 1327(b), (c).
43. It is important to reiterate that under Bankruptcy Rule 13-202, the same result follows if the bank fails to file a written rejection of the plan prior to the conclusion of the first meeting of creditors.
44. 11 U.S.C. § 1306(b).
Chapter 7 liquidation, creditors lack the power to elect a Chapter 13 trustee. Congress intended to encourage a system of private, standing Chapter 13 trustees who would not be "mere disbursing agents" but would provide financial counseling and "assist the debtor in the performance of the plan . . . ." Just how well this has worked out in practice is debatable. There is some indication that the limitation on trustee compensation in section 1302(e), coupled with the fact that private standing trustees are not subsidized, makes it financially difficult for Chapter 13 trustees to act as "mere disbursing agents" much less provide a variety of free debt counseling services to the public.

Be that as it may, the duties of a liquidation trustee are divided between the debtor and the trustee in Chapter 13 cases. The Chapter 13 debtor has, to the exclusion of the trustee, the power to sell and lease property of the estate, including the power to sell free and clear of liens. On the other hand, the Chapter 13 trustee is given the liquidation trustee's powers and duties of investigation, objection to claims and objection to discharge.

As a practical matter, however, a Chapter 13 trustee has neither possession of the property of the estate nor an obligation to liquidate the estate for the benefit of creditors. Consequently, the trustee would presumably not be interested in avoiding preferences under section 547 or fraudulent transfers under section 548. Indeed, using Chapter 13 as a device to mask preferences or fraudulent transfers is one potential abuse of the Chapter 13 process.

Of course, when a Chapter 13 case is converted to liquidation, the trustee then has the ability to pursue preferences or fraudulent transfers since a converted case relates back to the original filing date of the petition. There is a danger, though, that the issue would never arise because the Chapter 13 statement of affairs does not ask questions about transfers of property or repayment of

§ 1104 but this is not the norm.
47. 11 U.S.C. § 702.
49. Senate Report, supra note 24, at 139.
50. See In re Iacovoni, 1 C.B.C. 2d 331, 348 (B.C. D. Utah 1979)(where the court denied confirmation of zero and nominal payment plans in part because insufficient monies would be generated to pay the trustee).
52. 11 U.S.C. § 363. Note that the debtor's sale of property of the estate is also subject to the safeguards of this section.
53. 11 U.S.C. §§ 1302(b), 707.
debts.66

B. Confirmation Standards

The heart of Chapter 13 lies in sections 1322 and 1325. Section 1322(a) lists the mandatory plan elements; section 1322(b) lists the permissive elements of a plan. Section 1325 states the requirements for confirmation. When section 1325 is read with section 1322(a), a checklist of nine minimum elements for confirmation is derived. These elements are: (1) future income must be submitted to the trustee for the payment of debts;57 (2) priority claims must be paid in full;58 (3) like treatment must be provided for claims within the same class;59 (4) the filing fee must be paid;60 (5) the plan must have been "proposed in good faith and not by any means forbidden by law";61 (6) unsecured creditors must receive at least as much as they would on liquidation;62 (7) secured creditors must accept the plan, receive back their security or the plan must satisfy the cramdown requirements of the Code;63 (8) the plan must be feasible;64 and (9) the plan may last no longer than three years.65

If a plan meets these standards, the court is required to confirm it,66 although, as will be seen, the underlying concept of good faith gives the bankruptcy court ample discretion.

C. Good Faith as an Element of Confirmation

Of the above standards, the one that is the most central to the Chapter 13 debt adjustment process is the requirement that a plan be "proposed in good faith and not by any means forbidden by law."67 Through this standard Congress intended to inject needed flexibility into the individual debt adjustment process, while at the same time protecting against abuse resulting from that flexibility.

58. 11 U.S.C. § 1322(a)(2). Priority claims are listed in 11 U.S.C. § 507 and are, in general: administrative expenses; wages and fringe benefits accrued within 90 and 180 days of filing, respectively; deposits for household items; and taxes and custom duties.
60. 11 U.S.C. § 1325(a)(2).
64. 11 U.S.C. § 1325(a)(6).
65. 11 U.S.C. § 1322(c). The court may allow a plan for up to a total of five years "for cause."
The concept of good faith is not a new one to bankruptcy law and virtually identical language was used in several sections of the Bankruptcy Act. A substantial body of case law has developed on what is or is not good faith in various circumstances.68

For example, Chapter 13 has eliminated the requirement of Chapter XIII that unsecured creditors approve a plan and instead has substituted the “best interest of creditors” test. The test requires that unsecured creditors will receive “not less than the amount that would be paid on such claim if the estate of the debtor were liquidated . . . .”69 This means that in a no-asset liquidation case—that is, where the debtor has no assets over and above exempt property—a Chapter 13 plan involving no distribution to unsecured creditors could be confirmed. Likewise, the minimum payment acceptable for confirmation of a plan is the excess value of the debtor’s property over the value of exempt property.

While the best interest of creditors test obviously makes Chapter 13 more flexible, it also opens up possibilities for abuse. This is so principally because the test makes no reference to the debtor’s earnings or ability to pay. Also the hypothetical comparison to a liquidation involves assigning liquidation values to the debtor’s assets which are usually substantially less than either acquisition or replacement costs. This potential for abuse is compounded by the provision that a debtor’s property vests in the debtor upon confirmation of the plan and not upon consummation of the plan,70 and that a discharge under Chapter 13 allows a discharge of many otherwise non-dischargeable debts.71

Coupled with the apparent vagueness of the good faith standard, this potential for abuse has led to a wide array of decisions on when a Chapter 13 plan is filed “in good faith” and therefore may be confirmed. Some courts have held, by analogy to section 727(a)(9),72 that a plan must propose at least 70 percent payment

68. See, e.g., 11 U.S.C. §§ 1274, 1277(b). A detailed analysis of the good faith requirements of the various sections and chapters of the Bankruptcy Act and their effect on Chapter 13 of the Code is outside the scope of this article. For an excellent outline on the good faith standard under the Act with a discussion of leading cases, see Ordin, Good Faith in the Bankruptcy Court, in BANKR. LITIGATION INST.: STRATEGY FOR THE NEW LAW (1981) (Law & Business, Inc.).

70. 11 U.S.C. § 1327(b).
72. 11 U.S.C. § 727(a)(9). Essentially this section states that a Chapter 13 discharge prevents a discharge in a Chapter 7 case commenced within six years after the date of filing of a Chapter 13 petition, unless all unsecured creditors were paid in full or payments to unsecured creditors total 70 percent and “the plan was proposed by the debtor in good faith and was the debtor’s best effort.”
to unsecured claims to be eligible for confirmation. On the other hand, other courts routinely confirm zero payment plans on the holding that nothing beyond the "best interests of creditors" test needs to be satisfied for confirmation. Courts have divided on whether a plan, to be proposed in good faith, must be the debtor's best effort and whether the debtor's fraud, such as procuring credit by false financial statements, bars confirmation. To further complicate the matter, legislative history of this section is less than enlightening on what Congress intended by good faith.

Obviously, reconciliation of the cases on the issue of good faith is not possible. Nevertheless, it is possible to find certain indications of what Congress meant and therefore determine the type of plan that may be confirmed. The first point is almost self-evident. In using such an elastic term as good faith Congress clearly intended to adopt a flexible standard that would be applied on a case by case basis. Accordingly, cases that adopt mechanical, per se rules for confirmation, such as In re Burrell (70 percent distribution to unsecured creditors required) and In re Sadler (no distribution to unsecured creditors beyond best interest required), are clearly in error.

Secondly, Congress intended Chapter 13 to be something other than the liquidation under Chapter 7. A Chapter 13 plan that is essentially equivalent to a liquidation should not be confirmed. Plans proposing nominal or no payments to unsecured creditors are suspect. Such plans should be closely scrutinized to determine whether, from the point of view of benefit to creditors or rehabilitation of the debtor, there is any substantive distinction between the plan and liquidation. This does not mean that a zero or nominal payment plan can never be confirmed. Rather the debtor bears a greater burden of showing why the plan is proposed in good faith and is not in reality a disguised liquidation. An example of a clearly correct decision confirming nominal payment plans is In re Dills, in which the debtor previously paid 50 percent to

77. See Senate Report, supra note 24, at 142; House Report, supra note 9, at 430.
81. 7 B.R. 160 (B.C. E.D. Tenn. 1980).
the same unsecured creditors in a Chapter XIII plan that lasted nine years. Another example is *In re Bellgraph* where a disabled debtor whose sole income was from child support, social security and public assistance was attempting to save her home from foreclosure by paying off a secured creditor and taxes over a five-year period. This effort the court judge termed "a super effort to pay her debts."83

Third, while most courts require more than mere subjective good faith in order to confirm a Chapter 13 plan, a finding of subjective bad faith will always lead to denial of confirmation.84 So will plans that are found to be an abuse of Chapter 13.85 The difficulty is that some courts have considered it an abuse for debtors to take advantage of provisions inserted in the Code for their benefit.87

Fourth, bankruptcy courts have considered it relevant whether the debtor is attempting to discharge through Chapter 13 indebtedness that would be non-dischargeable under Chapter 7.88 If such debt is present, courts are not at all reluctant to make the debtor pay a greater price for discharge.89 Conversely, the lack of non-dischargeable debt is a factor in inducing some courts to confirm minimal payment plans on the reasoning that unsecured creditors have little to complain of, since they would receive nothing on liquidation.90

In summary, and although the cases are not in agreement, the courts are moving towards a five-part balancing test in determining whether a plan is proposed in good faith. Factors to be considered are:

(1) The percentage to be paid to unsecured creditors under the

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83. *Id.* at 424.
85. *In re Cole*, 3 B.R. 346 (B.C. S.D. W. Va. 1980) (zero payment to only creditor of significant amount who had a non-dischargeable tort judgment totaling three-quarters of debtor's annual income); *In re Lockwood*, 5 B.R. 294, 2 C.B.C. 2d 781 (B.C. S.D. Fla. 1980) (plan proposed by debtor's attorney who would make a profit of several thousand dollars on purchase of debtor's house that was worth more than debt against it).
86. *In re Lockwood*, 5 B.R. at 298, 2 C.B.C. 2d at 785.
plan;\(^91\)

(2) Presence or absence of debts non-dischargeable under Chapter 7;

(3) The debtor’s income and budget—that is, how close the plan comes to the debtor’s best effort;

(4) The length of the plan;\(^92\) and

(5) A catch-all category considering the totality of the circumstances, including classification of claims, redemption of secured collateral and previous bankruptcy. The test is whether it appears that the debtor has attempted to make a reasonable effort to be fair with creditors, or intends to abuse the spirit and purpose of Chapter 13.\(^93\)

D. Discharge

Once confirmed, a plan binds the debtor and all creditors “whether or not the claim of such creditor is provided for by the plan, and whether or not the creditor has objected to, has accepted, or has rejected the plan.”\(^94\) Confirmation also vests all property of the estate in the debtor free and clear of claims of creditors except as provided in the plan.\(^95\) Normally payments under the plan are made to the standing trustee.\(^96\) In an appropriate case, however, such as one involving a business debtor, the court may allow the debtor or a third person to be the disbursing agent.\(^97\) To expedite payment, the court may order the debtor’s employer to pay the trustee directly.\(^98\)

A debtor who has completed all payments provided for under the confirmed plan is entitled to a discharge under section 1328(a). This discharge is a unique facet of Chapter 13 since it discharges all debts except long term indebtedness,\(^99\) alimony and child sup-

\(^91\) No case denied confirmation where the plan proposed to pay unsecured creditors 50 percent or more of their debts. See, e.g., In re Powell, 1 C.B.C. 2d 371 (B.C. E.D. Va. 1980) (50 percent); In re Pearson, 4 B.R. 376, 2 C.B.C. 2d 290 (B.C. N.D. Ohio 1980) (70 percent).

\(^92\) Unless a substantial percentage is paid to unsecured creditors, courts tend to expect the plan to approach the statutory maximum of three years. See, e.g., In re Henry, 7 B.R. 826 (B.C. M.D. Tenn. 1980) (four months); In re Anderson, 3 B.R. 160, 2 C.B.C. 2d 594 (B.C. S.D. Cal. 1980) (15 months); In re White, 4 B.R. 349, 2 C.B.C. 2d 224 (B.C. E.D. Va. 1980) (27 months).


\(^94\) 11 U.S.C. § 1327(a).

\(^95\) 11 U.S.C. §§ 1327(b), (c).

\(^96\) 11 U.S.C. § 1326(b).

\(^97\) Id.

\(^98\) 11 U.S.C. § 1325(b); Bankruptcy Rule 13-213(b).

and taxes entitled to priority. All other debts made non-dischargeable under section 523 are discharged by a section 1328(a) discharge and include debts incurred through false pretenses or false financial statements, unscheduled debts, debts resulting from fraud, embezzlement or larceny, damages from willful and malicious injury to the person or property of another, fines, penalties and forfeitures, educational loans and debts as to which discharge was denied or waived in prior bankruptcy cases.

Obviously the mere recital of the types of debts dischargeable under section 1328(a) conjures up visions of perpetrators of fraudulent and criminal conduct escaping liability through nominal payments under a Chapter 13 plan. Nevertheless, the purpose of Congress in allowing expanded dischargeability through a successfully completed Chapter 13 plan was its belief that even in cases involving normally non-dischargeable debt, there should be an opportunity for financial rehabilitation and a fresh start. Also, the courts uniformly hold that plans that propose only nominal payments to victims of fraudulent or criminal conduct are not filed in good faith.

Section 1328(b) provides for a hardship discharge to a debtor not completing a plan if three conditions are met:

1. The debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;
2. The value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed

100. 11 U.S.C § 523(a)(5).
101. Technically, taxes entitled to priority are not an exception to a section 1328(a) discharge. Section 1322(a)(2), however, requires that a Chapter 13 plan must provide for full payment for claims entitled to priority under section 507, which includes tax claims entitled to priority.
103. 11 U.S.C. § 523(a)(3). Allowing unscheduled debts to be discharged via Chapter 13 presents an interesting due process problem since such creditors are given neither notice nor an opportunity to be heard concerning the Chapter 13 case. If the debtor deliberately omits a creditor from Chapter 13 schedules, some limited relief is available through section 1328(e), which allows revocation of a Chapter 13 discharge for one year after the discharge is granted, if the discharge was obtained through fraud and if knowledge of the fraud came to the requesting party after granting of the discharge.
109. See, e.g., In re Frederickson, 5 B.R. 199 (B.C. M.D. Fla. 1980).
unsecured claim is not less than the amount that would have been on such claim if the estate of the debtor had been liquidated under Chapter 7 of this title on such date; and
(3) [M]odification of the plan under section 1329 of this title is not practicable.110

A section 1328(b) discharge, unlike one under section 1328(a), is coextensive with a discharge granted in a Chapter 7 liquidation proceeding. It is subject to all the exceptions to discharge provided in section 523.111 Consequently, debtor’s counsel whose client has potential dischargeability problems, is well advised to propose a realistic plan in the first instance. Then, if the debtor is unable to complete payments under that plan, application may be made for a modification of the plan under section 1329,112 for example, to extend the term or reduce the payments, rather than applying for a hardship discharge.

While section 1329(b) purports to grant the court considerable discretion in granting a hardship discharge or requiring the debtor to continue with the plan, in fact, that discretion can be easily circumvented by converting the case to a liquidation. Section 1307(a) grants the debtor the absolute right to convert a Chapter 13 case to a liquidation “at any time.”113 If the case would have been a no-asset case under Chapter 7, or if the debtor’s payments to unsecured creditors under the plan, plus non-exempt assets remaining at conversion, equal what creditors would have received if the case had originally been filed under a liquidation, then the debtor’s discharge under section 727 should follow as a matter of course. If, however, during the course of the plan, the debtor has dissipated assets that would have been available for unsecured creditors, then discharge may be denied under section 727(a)(2).114 This section requires the trustee to prove that the diversion of estate property was “with intent to hinder, delay or defraud” and therefore would exclude unintended or merely negligent transfers of assets by the Chapter 13 debtor.

110. Section 1329 provides that a plan can be modified anytime after confirmation, but prior to completion of payments, to increase or decrease either the amount of payments or the length of the plan. The modified plan must generally meet the standards as an original plan for confirmation except that a confirmation hearing, as such, does not need to be held; only notice and hearing—that is, notice to the affected creditors and an opportunity to request a hearing. See 11 U.S.C. § 102(1).

111. 11 U.S.C. § 1328(c).


114. If the debtor is unable to “explain satisfactorily” what became of the estate property, discharge may also be denied under section 727(5).
A stated goal of Congress in enacting Chapter 13 was to make its provisions "more flexible." This increase in flexibility has resulted in a smorgasbord of features useful to the financially distressed debtor. A summary of these provisions and their potential uses follows.

A. Protection of Co-debtor

Section 1301 provides for extension of the automatic stay to co-debtors in Chapter 13 cases. The stay is limited to "consumer debts," which are debts incurred primarily for personal, family or household purposes, where the co-debtor is an individual (a natural person) who becomes a co-debtor other than in the ordinary course of business. The stay imposed by section 1301, therefore, by its terms, does not extend to such situations as guaranteed business debts, corporate sureties or recourse liability on sales contracts.

In addition, a creditor may, through an adversary proceeding, obtain relief from the stay "to the extent that" the co-debtor received consideration from the creditor or the debtor proposes not to pay the debt under the plan, or the creditor would be irreparably injured.

Section 1301 is a narrowly drafted statute designed to protect accommodation co-debtors of consumer debts—normally friends or relatives. Congress viewed pressure on such co-debtors which resulted in straight bankruptcy and reaffirmation as a major obstacle to the use of Chapter XIII under the Act. In decisions under the Code, bankruptcy courts have not hesitated to lift the section 1301 stay to the extent that the creditor is not to be paid under the plan, but have been reluctant to lift the stay totally on a creditor's claim of irreparable injury.

119. 11 U.S.C. § 1301(c).
120. House Report, supra note 9, at 426.
121. See, e.g., In re Willis, 2 B.R. 63 (B.C. W.D. Va. 1980).
122. See, e.g., In re Burton, 4 B.R. 608, 2 C.B.C. 2d 577 (B.C. N.D. Va. 1980) (where the court held the creditor to the common law burden of proving irreparable injury and ruled that the creditor failed in this burden by failing to show evidence that the credit standing of the co-debtor had changed).
B. Classification of Claims

Section 1322(b)(1) allows a plan to classify unsecured claims.\textsuperscript{123} This is in contrast to the Act which required a plan to deal “with unsecured debts generally, upon any terms.”\textsuperscript{124} There are several major limitations on the debtor’s right to classify. First, claims within a class must be “substantially similar to the other claims or interests of such class.”\textsuperscript{125} Secondly, the same treatment must be provided for each claim within a particular class.\textsuperscript{126} Third, the debtor may not “discriminate unfairly” among classes.\textsuperscript{127}

Most litigation on claim classification under the Code is centered around the debtor’s attempt to prefer cosigned obligations. The majority of courts have held that such classification is not permitted.\textsuperscript{128} Courts have uniformly held that alimony and child support may be separately classified and preferred\textsuperscript{129} and have allowed classification favoring medical bills,\textsuperscript{130} business debts\textsuperscript{131} and rent.\textsuperscript{132} Separate classification favoring holders of bad checks has been denied.\textsuperscript{133}

C. Installment Redemptions and Curing of Defaults

In a straight bankruptcy under Chapter 7, the debtor possesses a limited right to redeem collateral under section 722 by paying the creditor its value. The redemption right under section 722 is limited by its terms to “tangible personal property intended primarily for personal, family, or household use . . . .” By the clear majority of decisions, redemption under section 722 must be by a lump sum cash payment.\textsuperscript{134}

\textsuperscript{123} 11 U.S.C. § 1322(a)(3).
\textsuperscript{124} 11 U.S.C. § 1046(1) (1976) (Bankruptcy Act § 646(1)).
\textsuperscript{125} 11 U.S.C. § 1122 (incorporated by reference into 11 U.S.C. § 1322(a)(1)). An exception to this requirement is the debtor’s ability to designate a class of small claims for prior payment for administrative convenience under section 1122(b).
\textsuperscript{126} 11 U.S.C. § 1322(a)(3).
\textsuperscript{127} 11 U.S.C. § 1322(b)(1).
\textsuperscript{129} In re Curtis, 2 B.R. 43 (B.C. W.D. Mo. 1979); In re Haag, 3 B.R. 649, 2 C.B.C. 2d 144 (B.C. D. Or. 1980).
\textsuperscript{130} In re Sutherland, 3 B.R. 420 (B.C. W.D. Ark. 1980); In re Kovich, 4 B.R. 403, 2 C.B.C. 2d 203 (B.C. W.D. Mich. 1980).
\textsuperscript{131} In re Sutherland, 3 B.R. 420 (B.C. W.D. Ark. 1980).
\textsuperscript{133} In re Gay, 3 B.R. 336 (B.C. D. Colo. 1980).
\textsuperscript{134} See, e.g., In re Zimmerman, 4 B.R. 739, 2 C.B.C. 2d 650 (B.C. S.D. Cal. 1980).
Of course a debtor and a creditor in a Chapter 7 proceeding are free to negotiate a reaffirmation agreement under section 524(c). This does little good, however, if the value of the collateral is less than the debt against it. To induce the creditor to agree to reaffirmation and thereby allow installment payments, the debtor may be forced to agree to reaffirmation of the entire debt to preserve the option of installment payments. It is also possible that such a reaffirmation agreement may be disapproved by the court as not being in the best interest of the debtor under section 524(c)(4)(A)(ii).

By contrast, Chapter 13 authorizes compulsory installment redemption of any secured collateral except for a debt secured only by a security interest in real property used as the debtor's principal residence. This result is reached through section 1322(b)(2), which allows a plan to modify the rights of secured creditors, and section 1325(a)(5)(B), which provides that a plan may be confirmed over the objection of a secured claimant if the secured creditor retains a lien, and if the present value of property to be distributed under the plan is equal to the value of the security. For example, if a debtor owned an automobile worth $2,000 which was security for a debt of $3,000, the debtor could propose to pay the creditor $2,000 in installments plus interest, which would make the present value of the installment payments equal to the value of the collateral, $2,000. The cases setting interest or discount rates for redemption of secured collateral in Chapter 13 cases have varied widely. Rates range from the legal rate of interest to the contract rate of interest, to the prime rate, to rates set arbitrarily at 10 and 12 percent.

A Chapter 13 plan may also provide for the curing of any default and the maintenance of payments while the case is pending on any debt for which the final payment is due after the conclusion of the case. A default-curing provision in a plan may apply to a debt secured solely by real estate that is the debtor's principal residence, which debt would be otherwise immune from modification.

135. Section 1325(a)(5)(B) must be read in conjunction with section 506(a), which separates an undersecured claim into two components: a secured claim to the value of the collateral and an unsecured claim as to any excess.


141. 11 U.S.C. § 1322(b)(5).
under section 1322(b)(2). What is a reasonable period of time to cure a default is to be decided on a case by case basis. The issue has received little attention in litigation, although it has been held that six months is a reasonable time to cure a default, while three years is not.

D. Rejection of Executory Contracts and Compulsory Acceptance of Collateral

Section 1322(b)(7) allows the plan to reject any executory contract or unexpired lease “not previously rejected under section 365 . . . .” Rejection of such agreements is a device, often overlooked under Chapter 13, which permits a debtor to escape a burdensome contract or lease.

Once an executory contract or lease has been rejected, the debtor’s affirmative obligation of performance is terminated. The creditor has a claim for damages which is classified as a pre-petition, usually unsecured, claim. Section 502(7) provides a limitation on damages for termination of a lease on real property. While there is no express limitation on damages that can be claimed for termination of a lease on personal property, most financing leases on personal property calculate payments on the basis of an imputed interest rate, or use an interest rate-based premature termination factor. The debtor or trustee faced with such a claim should argue that to the extent the lessor’s claim for damages is for imputed unmatured interest, it should be disallowed under section 502(b)(2).

A Chapter 13 plan may also provide for compulsory acceptance of a portion of collateral by an oversecured creditor in satisfaction of that creditor’s debt. This is done through the interworkings of sections 1322(b)(2) and (b)(8) which permit a plan to modify the rights of secured creditors and to pay claims from property of the estate, and through section 1325(a)(5)(B), which sets the “cramdown” standard for confirmation of a Chapter 13 plan over the dissent of a secured creditor. The mechanics can best be shown by example. Suppose a debtor owes a creditor $3,000, which is secured by a security interest in two motor vehicles, one worth $3,000 and the other $5,000. The plan could propose that the $3,000 vehicle be surrendered to the creditor in satisfaction of the debt. Under section 1325(a)(5)(B), the court could confirm

144. 11 U.S.C. § 365(g).
such a plan notwithstanding the wishes of the secured creditor and it would probably do so, if it found that the value of the collateral surrendered equaled the amount of the debt.

Counsel for either debtors or creditors faced with compulsory acceptance of collateral should be aware that under section 506(b), an oversecured creditor is entitled to post-filing interest, and fees and costs (such as attorneys' fees) provided for under the agreement under which the claim arose.

E. Business Debtors

One drastic change by the Code expands Chapter 13 to include persons engaged in business. The expansion is limited to smaller proprietorships, since Chapter 13 may only be used by "individuals with regular income" who owe less than $100,000 in unsecured debts and $350,000 in secured debts that are both noncontingent and liquidated. This plainly excludes partnerships, corporations and proprietorships with debts greater than those specified in section 109(e).

For the proprietor who comes within these terms, Chapter 13 offers substantial advantages over a Chapter 11 reorganization, including:

(1) No creditors' committee is appointed; 146
(2) The plan may be substantially simpler than a Chapter 11 plan; 147
(3) No disclosure statement is required; 148
(4) Acceptance of the plan by unsecured creditors is not required; 149
(5) Secured creditors can be satisfied by transfer of presently owned property or by deferred cash payments or a combination; 150
(6) The debtor is entitled to an expanded discharge on successful completion of the plan including debts that might be non-dischargeable under Chapter 11. 151

These factors in combination result in significant savings in time and expense in reorganizing a small proprietorship. This is

145. 11 U.S.C. § 109(e). The Code is silent about how far debtor may go by pre-petition transaction, such as dissolution of partnership or corporation, or transferring property in partial satisfaction of debts to bring the plan within the limits of Chapter 13.
146. 11 U.S.C. § 102. There is no comparable provision under Chapter 13.
exactly what Congress intended. Since Chapter 13 can accomplish any form of reorganization for an individual that could be accomplished under Chapter 11, there would be no reason for filing a Chapter 11 reorganization for a proprietor eligible for relief under Chapter 13.

IV. CONCLUSION

As this article has noted, Chapter 13 has many areas of potential abuse. On balance, however, it represents a positive step forward in bankruptcy law. The flexibility it grants obviously benefits the debtor by releasing the arbitrary restriction of Chapter XIII. Creditors also benefit to the extent that they are paid more through Chapter 13 than they would be through liquidation.

In enacting the Code, Congress expressed the belief that most debtors are basically honest persons experiencing financial misfortune through inadvertance, lured on by the pressures of a consumer credit society. Congress concluded that it is unfair to penalize the honest majority for the abuses of a dishonest minority. Yet, those potential abuses remain and can only be dealt with through vigilence by creditors, bankruptcy personnel and the courts.

152. House Report, supra note 9, at 119.
153. Id. at 116.