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## Payments to Unsecured Creditors Under Chapter 13 of the Bankruptcy Reform Act of 1978

Chapter 13<sup>1</sup> of the Bankruptcy Reform Act of 1978<sup>2</sup> has revitalized a form of bankruptcy under which debtors repay their creditors over time with the approval and protection of the bankruptcy court.<sup>3</sup> The main source of payment to creditors under chapter 13 is the debtor's future income.<sup>4</sup> In contrast, a "straight" bankruptcy under chapter 7 of the Act requires a liquidation of the debtor's nonexempt assets and a distribution of the proceeds to creditors.<sup>5</sup> The debtor who chooses chapter 13 proposes a plan of payments which the court either confirms or rejects.<sup>6</sup> If the plan is confirmed, the debtor can carry out the proposed payments free from harassment by creditors.<sup>7</sup> Soon after performance of a confirmed plan is completed, the debtor receives a discharge of indebtedness.<sup>8</sup>

A great controversy has developed among both courts<sup>9</sup> and commentators<sup>10</sup> regarding the amount of payments that must be proposed to unsecured creditors for confirmation of a chapter 13 plan. The only requirement

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<sup>1</sup> 11 U.S.C. §§ 1301-1330 (Supp. IV 1980). For a thorough discussion of the background of chapter 13, see *In re Scher*, [1981] 7 BANKR. CT. DEC. (CCR) 979; *In re Hurd*, 4 Bankr. 551 (Bankr. W.D. Mich. 1980).

<sup>2</sup> 11 U.S.C. §§ 101-151326 (Supp. IV 1980).

<sup>3</sup> Participation in the new chapter 13 has more than doubled compared to the number of individuals who filed repayment plans during the last full year of its predecessor, chapter XIII of the Chandler Act, 11 U.S.C. §§ 1001-1086 (1976) (current version at 11 U.S.C. §§ 1301-1330 (Supp. IV 1980)). Cyr, *The Chapter 13 "Good Faith" Tempest: An Analysis and Proposal for Change*, 55 AM. BANKR. L.J. 271, 272 n.6 (1981).

<sup>4</sup> 5 W. COLLIER, BANKRUPTCY ¶ 1322.01[1]-[2] (15th ed. 1981).

<sup>5</sup> 11 U.S.C. §§ 701-728 (Supp. IV 1980). Assets that are exempt from creditors' claims are set out in *id.* § 522.

<sup>6</sup> *Id.* §§ 1321-1326.

<sup>7</sup> *Id.* §§ 362(c), 1327.

<sup>8</sup> *Id.* § 1328(a).

<sup>9</sup> See notes 13-17 & accompanying text *infra*.

<sup>10</sup> Compare Note, *Good Faith, Zero Plans, and the Purposes of Bankruptcy Code Chapter 13: A Legislative Solution to the Controversy*, 61 B.U.L. REV. 773 (1981) [hereinafter cited as Note, *Legislative Solution*] (zero payment plans should be rejected in order to effectuate spirit and purpose of statute), and Note, *Bankruptcy: Good Faith and the Zero Payment Plan in Chapter 13*, 69 KY. L.J. 326 (1981) [hereinafter cited as Note, *Zero Payment Plan*] (zero or nominal payment plans violate "good faith" requirement and should not be confirmed), and Note, *Abusing Chapter 13 of the Bankruptcy Code: The Problem of Nonrepayment*, 55 N.Y.U. L. REV. 941 (1980) [hereinafter cited as Note, *Abusing Chapter 13*] ("abusive" plans should be rejected on basis of history and purpose of the statute), with Note, *Chapter 13 De Minimis Plans: Toward a Consensus on "Good Faith,"* 9 HOFSTRA L. REV. 593 (1981) [hereinafter cited as Note, *De Minimis Plans*] (nominal payment plans can be confirmed if debtor has dealt fairly with his creditors), and Note, *"Good Faith" and Confirmation of Chapter 13 Composition Plans: Analysis and a Proposal*, 65 MINN. L. REV. 659 (1981) [hereinafter cited as Note, *Composition Plans*] (zero payment plans can be confirmed if they represent the debtor's "best effort").

that deals specifically with the plan's treatment of general unsecured creditors is found in section 1325(a)(4) of chapter 13: the value of property to be distributed to each creditor must be "not less than" what would be paid to that creditor under chapter 7.<sup>11</sup> The Act's legislative history, however, indicates that Congress expected creditors to be paid *more* if a debtor chooses to proceed under chapter 13 instead of chapter 7.<sup>12</sup> Some courts rely extensively on the legislative history in determining payment requirements;<sup>13</sup> others focus on the language of section 1325(a)(4).<sup>14</sup>

The benefits of chapter 13 that are not available under chapter 7 have added to the confusion surrounding the issue of payments to unsecured creditors. Many courts have found that the requirement of section 1325(a)(3) that the plan be "proposed in good faith"<sup>15</sup> is not satisfied if the debtor takes advantage of the more complete relief of chapter 13 without proposing "substantial" payments to general unsecured creditors.<sup>16</sup> Other courts have confirmed chapter 13 plans that propose no payments at all to unsecured creditors.<sup>17</sup>

This note proposes an approach that occupies a middle ground in the controversy over chapter 13 payments. The note suggests that the benefits of chapter 13 do not compel a burden of particularly high payments, but statutory language that has generally been ignored in this context is interpreted to impose a requirement of some payment to general unsecured creditors. The note concludes that "good faith" imposes a requirement of a reasonable effort to pay creditors.

#### SUMMARY OF CHAPTER 13 AND ITS SPECIAL BENEFITS

The central element of a chapter 13 proceeding is the repayment plan filed by the debtor.<sup>18</sup> The plan may propose payments to creditors over

<sup>11</sup> 11 U.S.C. § 1325(a)(4) (Supp. IV 1980).

<sup>12</sup> The House Report states: "[T]he bill requires only that creditors receive under the plan more than they would if the debtor went into straight bankruptcy." H.R. REP. NO. 595, 95th Cong., 1st Sess. 123-24 (1977), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5963, 6084-85. The Senate Report states: "It is also necessary to prevent chapter 13 plans from turning into mere offers of composition plans under which payments would equal only the non-exempt assets of the debtor." S. REP. NO. 989, 95th Cong., 2d Sess. 13 (1978), *reprinted in* [1978] U.S. CODE CONG. & AD. NEWS 5787, 5799.

<sup>13</sup> *E.g.*, *In re Bloom*, 3 Bankr. 467 (Bankr. C.D. Cal. 1980); *In re Iacovoni*, 2 Bankr. 256 (Bankr. D. Utah 1980).

<sup>14</sup> *E.g.*, *In re Harper*, 11 Bankr. 395 (Bankr. N.D. Ga. 1981); *In re Cloutier*, 3 Bankr. 584 (Bankr. D. Colo. 1980).

<sup>15</sup> 11 U.S.C. § 1325(a)(3) (Supp. IV 1980).

<sup>16</sup> *E.g.*, *In re Marsch*, 11 Bankr. 514 (Bankr. D.R.I. 1981) (25% payment plan rejected); *In re Howard*, 3 Bankr. 75 (Bankr. S.D. Cal. 1980) (8% payment plan rejected); *In re Burrell*, 2 Bankr. 650 (Bankr. N.D. Cal. 1980) (15% payment plan rejected); *rev'd & remanded*, 6 Bankr. 360 (N.D. Cal. 1980).

<sup>17</sup> *E.g.*, *In re Carter*, 9 Bankr. 140 (Bankr. N.D. Ga. 1981); *In re Thebeau*, 3 Bankr. 537 (Bankr. E.D. Ark. 1980).

<sup>18</sup> 11 U.S.C. §§ 1321-1330 (Supp. IV 1980).

a maximum period of three years; with court approval, the plan may extend up to five years.<sup>19</sup> The debtor decides on the amount of payments to be proposed after subtracting living expenses from anticipated income.<sup>20</sup> The plan must provide full payment of priority unsecured claims, which include administrative expenses, employee salaries, and taxes.<sup>21</sup> The court must confirm the plan if six criteria set out in section 1325(a) are fulfilled.<sup>22</sup>

The most obvious advantage of chapter 13 is that it allows a debtor to keep his property, including assets that would be nonexempt and therefore subject to creditors' claims under chapter 7.<sup>23</sup> Moreover, while chapter 7 debtors generally must surrender property that secures a claim,<sup>24</sup> the chapter 13 debtor may elect to keep the collateral and "cram down" the secured creditor.<sup>25</sup> "Cram down" involves giving the secured creditor property that is worth "not less than" the value of the collateral.<sup>26</sup> If the collateral is worth less than the outstanding indebtedness, the payments

<sup>19</sup> *Id.* § 1322(c).

<sup>20</sup> BANKR. R.P. Form 13-5.

<sup>21</sup> 11 U.S.C. § 1322(a)(2) (Supp. IV 1980).

<sup>22</sup> (a) The court shall confirm a plan if—

- (1) the plan complies with the provisions of this title;
- (2) any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;
- (3) the plan has been proposed in good faith and not by any means forbidden by law;
- (4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;
- (5) with respect to each allowed secured claim provided for by the plan—
  - (A) the holder of such claim has accepted the plan;
  - (B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and
    - (ii) the value as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or
  - (C) the debtor surrenders the property securing such claim to such holder; and
- (6) the debtor will be able to make all payments under the plan and to comply with the plan.

*Id.* § 1325(a).

<sup>23</sup> *Id.* §§ 1306(b), 1327(b).

<sup>24</sup> An exception arises if the property securing a claim is exempt under § 522, and it is tangible personal property intended for personal, family, or household use. In such cases the debtor may redeem the property at the time of the liquidation by paying the creditor the amount of the allowed secured claim. *Id.* § 722. A claim is secured only to the extent of the value of the collateral. *Id.* § 506.

<sup>25</sup> *Id.* § 1325(a)(5)(B). See also 5 W. COLLIER, *supra* note 4, ¶ 1325.01[2][E][2][b], at 1325-21 to 1325-27; Note, *Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of the Secured Creditor*, 1981 WIS. L. REV. 333.

<sup>26</sup> Future payments on secured claims are valued "as of the effective date of the plan," to ensure that the creditor receives the equivalent of an immediate surrender of the collateral. 11 U.S.C. § 1325(a)(5)(B)(ii) (Supp. IV 1980); W. COLLIER, *supra* note 4, ¶ 1325.01[2][E][2][b], at 1325-23 to 1325-24.

needed to cram down the creditor may be much lower than the payments required by the loan agreement.<sup>27</sup>

If the chapter 13 debtor completes all payments proposed by the confirmed plan, he is allowed a very broad discharge of debts.<sup>28</sup> This "super discharge" includes debts that may not be discharged under chapter 7, such as student loans, debts for obtaining money by false pretenses or embezzlement, and debts incurred for willful and malicious injury by the debtor.<sup>29</sup> The only debts that may not be discharged under chapter 13 are for alimony or child support<sup>30</sup> and debts on which the last payment is due after the plan is to be completed.<sup>31</sup> If the debtor fails to complete all payments as proposed, he is eligible for a hardship discharge if three conditions are met.<sup>32</sup> The hardship discharge is only equal to the chapter 7 discharge.<sup>33</sup>

The Bankruptcy Reform Act, like its predecessor,<sup>34</sup> limits the frequency with which a debtor may take advantage of chapter 7 relief. A discharge will not be granted in a chapter 7 case commenced within six years after the filing of a petition in another liquidation which resulted in a discharge.<sup>35</sup> The Act also restricts access to a chapter 7 discharge when prior relief under chapter 13 has been granted.<sup>36</sup> The Act places no limits, however, on how often a debtor may receive a chapter 13 discharge.

Unlike prior law,<sup>37</sup> approval by a majority of the unsecured creditors is not required for confirmation of a chapter 13 plan. Section 1325(a)(4), known as the "best interests of creditors" test, requires only that distributions to unsecured creditors be "not less than" what would be paid in a liquidation under chapter 7.<sup>38</sup> In most bankruptcies all the debtor's assets

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<sup>27</sup> See, e.g., *In re Campbell*, 3 Bankr. 57 (Bankr. S.D. Cal. 1980).

<sup>28</sup> 11 U.S.C. § 1328(a) (Supp. IV 1980).

<sup>29</sup> *Id.* § 523(a). The super discharge is in great danger of being repealed. Both houses of Congress have passed versions of a bill that would abolish the broader discharge in whole or in part. S. 658, 96th Cong. 2d Sess., § 130, 126 CONG. REC. S15170, S15176 (daily ed. Dec. 1, 1980); S. 658, 96th Cong., 2d Sess., § 129, 126 CONG. REC. H11735, H11740 (daily ed. Dec. 3, 1980). See also Bankruptcy Amendments Act of 1981, S. 863, 97th Cong., 1st Sess. § 130, 127 CONG. REC. S7904 (daily ed. July 17, 1981).

<sup>30</sup> 11 U.S.C. § 1328(a)(2) (Supp. IV 1980).

<sup>31</sup> *Id.* § 1328(a)(1).

<sup>32</sup> The hardship discharge is allowed if, first, the failure to complete payments is due to circumstances for which the debtor should not be held accountable; second, if modification of the plan under § 1329 is not practicable; and third, if the value of property actually distributed to unsecured creditors is not less than what would have been paid under a liquidation. *Id.* § 1328(b).

<sup>33</sup> *Id.* § 1328(c).

<sup>34</sup> 11 U.S.C. § 32(c)(5) (1976) (current version at 11 U.S.C. § 727(a)(8)-(9) (Supp. IV 1980)).

<sup>35</sup> 11 U.S.C. § 727(a)(8) (Supp. IV 1980).

<sup>36</sup> In order to receive another discharge in a chapter 7 case commenced within the six year limitation period after a chapter 13 case, the debtor must have paid 100% of unsecured claims in the chapter 13 case or paid at least 70% of the unsecured claims and proposed in good faith a plan that was the debtor's best effort. *Id.* § 727(a)(9).

<sup>37</sup> 11 U.S.C. § 1052 (1976) (repealed 1978).

<sup>38</sup> 11 U.S.C. § 1325(a)(4) (Supp. IV 1980).

are exempt, providing no source of payment to unsecured creditors in a liquidation.<sup>39</sup> In such cases the best interests test is satisfied by a chapter 13 plan that proposes no payments to general unsecured creditors. This note will refer to such plans as "zero payment plans."

### CHAPTER 13 BENEFITS AND THEIR EFFECT ON PAYMENT REQUIREMENTS

#### *Good Faith and the Benefits*

A recurrent theme in many of the reported cases is the concern that a debtor should not be allowed the special benefits of chapter 13 unless he proposes to make "substantial" payments to unsecured creditors.<sup>40</sup> Several attempts have been made to develop a legitimate statutory justification for rejecting zero payment plans; these efforts have been unconvincing, however.<sup>41</sup>

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<sup>39</sup> REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 137 (pt. 1), 93d Cong., 1st Sess. 104-05, 123, 135-36, 150, 162 (1973) [hereinafter cited as BANKRUPTCY COMMISSION REPORT].

<sup>40</sup> See, e.g., *In re Hall*, 4 Bankr. 341, 342 (Bankr. E.D. Va. 1980) (court acknowledged that most courts "have reached the conclusion based on the legislative history, the generous discharge provisions and the purpose and spirit of a chapter 13 proceeding, that substantial and meaningful payment to unsecured creditors is required for a chapter 13 plan to be confirmed as being proposed in good faith"); see cases cited note 16 *supra*.

<sup>41</sup> At least one court found statutory authority to reject zero payment plans under § 1307(c), which allows a court to dismiss a case or convert it to chapter 7 "for cause." *In re Seman*, 4 Bankr. 568 (Bankr. S.D.N.Y. 1980). The court found that the incompatibility of zero payment plans with the statutory scheme was sufficient cause for rejecting them. *Id.* at 572. Section 1307(c) does not authorize *rejecting* a plan, however, and therefore does not create any statutory basis for rejection beyond the requirements of § 1325(a). Although § 1307(c) lists "denial of confirmation of a plan *under section 1325*" as sufficient cause for dismissing or converting a case, 11 U.S.C. § 1307(c)(4) (Supp. IV 1980) (emphasis added), the *Seman* court did not rely on § 1325.

The "best interests of creditors" test in § 1325(a)(4) has been used to reject plans that take advantage of the super discharge. *In re Chaffin*, 4 Bankr. 324 (Bankr. D. Kan. 1980). The creditor whose debt is subject to the super discharge would retain the right to pursue the debtor after a chapter 7 discharge. The argument is that the creditor must be paid in full under chapter 13 in order to receive not less than what he would receive in a liquidation. The major flaw in this argument is that the right to collect the debt that is retained under chapter 7 is not property that is distributed from the debtor's estate, and is therefore irrelevant to the "best interests" test. See *In re Marlow*, 3 Bankr. 305, 308 (Bankr. N.D. Ill. 1980). The suggested interpretation would in effect render the debt non-dischargeable, a result which is contrary to the language of § 1328(a). See notes 28-29 & accompanying text *supra*. The interpretation would also require separate classification for the debt that is included in the super discharge, which may not be allowed. See notes 63-64 & accompanying text *infra*.

At least one court has argued that the "best interests" test requires that unsecured creditors receive "more than" what would be paid under chapter 7. *In re Iacovoni*, 2 Bankr. 256, 266 (Bankr. D. Utah 1980). The court suggested that the words "not less than" were chosen for the benefit of debtors whose assets would yield full payment to creditors in a liquidation. *Id.* These debtors obviously should not be required to pay more than 100%

The majority of courts that reject zero payment plans rely on the good faith requirement of section 1325(a)(3).<sup>42</sup> The courts bolster their decisions with the legislative history expressing Congress' expectations that creditors would be paid more when a debtor chooses chapter 13 instead of liquidation.<sup>43</sup> Commentators have observed, however, that the statute and legislative history offer no definition of "good faith," much less any indication that good faith was to be evaluated in light of the special benefits of chapter 13.<sup>44</sup> Some courts have acknowledged that the generally understood meaning of "good faith" cannot justify a requirement of substantial payments;<sup>45</sup> they have simply invented a new meaning to accommodate their interpretation of congressional intent.

*Congressional Intent and the Benefits of Chapter 13*

The courts that impose payment requirements based on the benefits of chapter 13 have ignored the most obvious explanation for Congress' intent in providing the benefits. The expectations of greater payments to creditors found in the legislative history were not based on the benefits provided in chapter 13, but on the premise that debtors want to pay their creditors, and that many debtors will propose full payment if given the

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of their indebtedness; in all other cases, the court argues, "more than" was intended. The phrase "not less than" is clear on its face, however; there is no room for such interpretation when applying § 1325(a)(4). See *In re Cloutier*, 3 Bankr. 584, 585 (Bankr. D. Colo. 1980).

For a discussion of a rationale based on § 1325(a)(3), see notes 42-45 & accompanying text *infra*.

<sup>42</sup> See, e.g., *In re Terry*, 630 F.2d 634 (8th Cir. 1980); *In re Cook*, 3 Bankr. 480 (Bankr. S.D. W. Va. 1980).

<sup>43</sup> See note 12 *supra*.

<sup>44</sup> See Note, *Composition Plans*, *supra* note 10, at 667-71; Note, *De Minimis Plans*, *supra* note 10, at 621 n.191. Many courts argue that good faith is lacking when a debtor proposes to take advantage of the more liberal chapter 13 relief with a plan that is quantitatively equivalent to a liquidation. These courts characterize nominal payment plans as attempts to deceive the court into granting relief that the debtor is not entitled to. See, e.g., *In re Chaffin*, 4 Bankr. 324 (Bankr. D. Kan. 1980); *In re Bloom*, 3 Bankr. 467 (Bankr. C.D. Cal. 1980); *In re Campbell*, 3 Bankr. 57 (Bankr. S.D. Cal. 1980). However, a debtor who has disclosed a lack of ability to pay unsecured creditors is hardly guilty of deceit or bad faith. The debtor's legitimate intent is to receive the best possible relief, a motive that is shared by all debtors. One court that rejects any inference of improper motive or intent states that "[t]here is a latent assumption in many of the opinions which I have examined that the desire of debtors to go through bankruptcy proceedings on the most favorable terms permissible under the Code is in itself an act of bad faith . . ." *In re Koerperich*, 5 Bankr. 752, 755 (Bankr. D. Neb. 1980). It is illogical to find that a debtor who intends to pay creditors all that he can reasonably afford is lacking good faith because of the amount he proposes to pay.

<sup>45</sup> E.g., *In re Iacovoni*, 2 Bankr. 256, 268 (Bankr. D. Utah 1980) ("The Court's interpretation of 'good faith' as used in Chapter 13 follows no traditional bankruptcy meaning of the phrase; neither is this interpretation meant to apply nor can it logically extend, to any similar phrase elsewhere in the law.").

right opportunity.<sup>46</sup> Congress showed little concern for establishing particularly high payment percentages that would be required of all debtors; of great concern to the drafters, however, was encouraging more debtors to choose repayment plans over liquidation.<sup>47</sup> The expansion of chapter 13 eligibility to include more debtors,<sup>48</sup> and the provisions for more complete relief, must have been designed to increase participation in chapter 13.

The need for incentives to attract debtors becomes evident when the prospect of paying off debts for up to three years under chapter 13 is compared with straight bankruptcy. Chapter 7 provides a quick discharge of debts and requires no continuing effort or sacrifice. Moreover, the stigma associated with straight bankruptcy may be diminishing.<sup>49</sup> Significant advantages to outweigh the burdens of debt repayment are therefore an integral part of chapter 13. The goal of attracting debtors is substantially undermined when the advantages are linked to payment requirements.<sup>50</sup>

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<sup>46</sup> "We found that most of these people truly want to repay their debts. But the procedure for repayment for individual debtors, chapter XII [*sic*], isn't working well. Its scope is too limited—the requirements for eligibility are too narrow." 123 CONG. REC. 35,446 (1977) (remarks of Rep. Edwards). "First, and most important, we make it easier for debtors to repay their debts under the supervision and protection of the bankruptcy laws." *Id.*

The House Report states: "The hearings before the Subcommittee indicated strongly that most consumer debtors would rather work out a repayment plan than file straight bankruptcy. They opt for straight bankruptcy only because present chapter XIII simply cannot meet their needs." H.R. REP. NO. 595, *supra* note 12, at 117.

<sup>47</sup> "The premises of the bill with respect to consumer bankruptcy are that use of the bankruptcy law should be a last resort; [and] that if it is used, debtors should attempt repayment under chapter 13, Adjustment of Debts of an Individual with Regular Income . . ." H.R. REP. NO. 595, *supra* note 12, at 118. "In the consumer area, proposed chapter 13 encourages more debtors to repay their debts over an extended period rather than to opt for straight bankruptcy liquidation and discharge." *Id.* at 5.

<sup>48</sup> See note 52 & accompanying text *infra*.

<sup>49</sup> *A Rush to Personal Bankruptcy*, NEWSWEEK, Aug. 11, 1980, at 59. It also is not clear that chapter 13 debtors who make less than full payment will not suffer some stigma or damage to their credit rating, see 5 W. COLLIER, BANKRUPTCY, ¶ 1300.01, at 1300-18 n.31 (15th ed. 1979), even though Congress clearly expected that these problems would not be experienced under chapter 13, H.R. REP. NO. 595, *supra* note 12, at 118.

<sup>50</sup> Two cases illustrate the unfair and improper decisions that can result from a preoccupation with the benefits of chapter 13. In *In re Ponanski*, 11 Bankr. 661 (Bankr. D.R.I. 1981) the court considered the plan of a debtor who took home \$919.34 a month and offered to pay creditors \$219.34 a month for 36 months. Although the debtor's plan appeared to be a strong effort, the court incorrectly rejected it because more than half of his total debt consisted of student loans which would have been nondischargeable under chapter 7. *Id.* at 662.

The court in *In re Howard*, 3 Bankr. 75 (Bankr. S.D. Cal. 1980), rejected a plan that proposed to pay only one percent of unsecured indebtedness in five monthly payments. The debtors then proposed a stronger plan which would yield an eight percent dividend to unsecured creditors and which was based in part on cuts in the original plan's budget. *Id.* at 76. The court rejected the new plan for lack of good faith, calling it "a disguised Chapter 7 Liquidation." *Id.* What was particularly unfair was the court's alternative finding that because the debtors would be unable to make the payments, the plan could be



The most logical view of congressional intent is that the drafters decided that the likelihood of large payments in many, but not all, cases was sufficient to justify the special benefits of chapter 13. This interpretation is supported by the measures enacted to reform the old chapter XIII. First, Congress eliminated the requirement of creditor approval, yet did not add a requirement of substantial payments.<sup>51</sup> Further, in expanding chapter 13 eligibility standards to include even debtors who receive public assistance,<sup>52</sup> Congress could not have expected large payments in all cases. Finally, the old chapter XIII was criticized for its tendency to result in full payment plans that debtors could not afford.<sup>53</sup> The new law was designed to be more flexible in accommodating the debtor's individual circumstances,<sup>54</sup> which is not compatible with a uniform requirement of large payments.

Congress may have been overoptimistic in gauging the willingness and ability of debtors to pay unsecured creditors under a chapter 13 plan. In view of the clear intent to increase participation and to provide flexible standards for evaluating payment plans, however, some courts have gone too far in converting Congress' vague predictions of debtor behavior into requirements for all cases.<sup>55</sup>

*Specific Benefits of Chapter 13 and Their Possible  
Effect on Payment Requirements*

At least one court, in *In re Cook*,<sup>56</sup> has used good faith to develop a sliding scale of payment requirements, under which "the adequacy of the plan depends upon the extent to which the debtor is invoking the special relief afforded by the Chapter."<sup>57</sup> While this analysis is burdened with

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rejected under § 1325(a)(6). *Id. Howard* placed the debtors in a Catch-22 situation: the court found that the proposed payments were insufficient; however, when the debtors adjusted their budget to provide for greater payments, the court said the plan was unfeasible.

<sup>51</sup> *But see In re Burrell*, 6 Bankr. 360, 364 (N.D. Cal. 1980) (requirement of substantial payments to unsecured creditors carries over from prior law, since it was not unambiguously abolished by present statute).

<sup>52</sup> "Even individuals whose primary income is from investments, pensions, social security, or welfare may use chapter 13 if their income is sufficiently stable and regular. This expansion of eligibility will enable many to work out arrangements with their creditors rather than seeking straight bankruptcy liquidation." H.R. REP. NO. 595, *supra* note 12, at 119. "The new chapter 13 will permit almost any individual with regular income to propose and have approved a reasonable plan for debt repayment based on that individual's exact circumstances." S. REP. NO. 989, *supra* note 12, at 13.

<sup>53</sup> "Under present law, the consent requirement often prevents a debtor from making a legitimate offer of less than full payment, for fear that the offer will not obtain the requisite consents. Instead, the debtor, unable to pay his debts in full within a reasonable period, will opt for liquidation." H.R. REP. NO. 595, *supra* note 12, at 123.

<sup>54</sup> See note 52 *supra*.

<sup>55</sup> See notes 16 & 50 *supra*.

<sup>56</sup> 3 Bankr. 480 (Bankr. S.D. W. Va. 1980).

<sup>57</sup> *Id.* at 486.

the same flaws common to other broad interpretations of "good faith,"<sup>58</sup> it is the most logical and fairest way to link payment requirements to the special benefits of chapter 13. The sliding scale approach will be accepted for purposes of argument in order to demonstrate that the advantages of chapter 13 do not compel a particular amount of distributions to general unsecured creditors.

Two advantages of chapter 13 should not result in a compensating requirement of large payments. The cram down option and the ability to keep even nonexempt property are both offset by burdens on the debtor who uses them. When a debtor keeps collateral securing a claim, he must part with income or other assets with a present value equal to that of the collateral.<sup>59</sup> Similarly, when a debtor chooses to keep nonexempt property, the best interests test requires that unsecured creditors receive payments that are at least equal to the distributions that would result from a liquidation of the property.<sup>60</sup> The payment requirements built into these provisions should satisfy courts that believe that a debtor must earn the advantages of chapter 13.

The super discharge and the unlimited frequency of discharge allowed under chapter 13 are more dramatic advantages because they allow discharge of claims that are nondischargeable in a liquidation. When the super discharge is used, however, it is illogical to raise payment requirements on *all* unsecured claims merely because one particular debt is included in a plan.<sup>61</sup> If, as advocated in *Cook*, the adequacy of a debtor's proposed payments depends on the relief to be obtained under chapter 13, any higher payment should be imposed only on debts that are nondischargeable under chapter 7. Such logical consistency to the analysis of *Cook* creates serious difficulties, however. First, requiring large payments that may be beyond the debtor's ability tends to undermine the statutory provisions allowing the debt to be dischargeable.<sup>62</sup> An even thornier problem is that in order to pay more on a particular unsecured

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<sup>58</sup> See notes 44-47 & accompanying text *supra*.

<sup>59</sup> 11 U.S.C. § 1325(a)(5)(B) (Supp. IV 1980). See notes 24-27 & accompanying text *supra*.

<sup>60</sup> 11 U.S.C. § 1325(a)(4) (Supp. IV 1980).

<sup>61</sup> See *In re Marlow*, 3 Bankr. 305, 308 (Bankr. N.D. Ill. 1980).

<sup>62</sup> Some courts may feel a need to restrict use of the super discharge because of the kinds of debts involved. Certainly it would be a legitimate legislative decision to prohibit discharge of some debts, particularly those incurred through intentional misconduct. See note 29 & accompanying text *supra*. As long as the super discharge is allowed, however, courts should not be concerned with the nature of the debts to be discharged.

One commentator proposes a legislative change requiring that debts that are nondischargeable under chapter 7 be satisfied before any payments can be applied toward other unsecured debts. Note, *Abusing Chapter 13*, *supra* note 10, at 967-68. This measure may be appropriate in view of Congress' apparent reluctance to retain the super discharge, see note 29 *supra*; however, to the extent that nonfavored creditors receive nothing the goal of reducing creditors' losses, see note 112 *infra*, is not realized.

debt the debtor must classify it separately in his plan;<sup>63</sup> a classification based on nondischargeability under chapter 7 may not be permissible.<sup>64</sup>

The structure of chapter 13 nevertheless supports a requirement of some payments to unsecured creditors when the super discharge is used. The chapter 13 debtor who proposes payments to general unsecured creditors but fails to complete the plan might receive only the narrower hardship discharge.<sup>65</sup> If a plan proposing no payments on unsecured claims is confirmed, however, the debtor is likely to receive the full discharge even if he fails to complete payments on secured claims.<sup>66</sup> The debtor who tries to pay unsecured creditors and then fails may be penalized if his plan includes debts that are nondischargeable under chapter 7.<sup>67</sup> Although some payments should be proposed on unsecured claims to avoid this unfair result, the inequity does not justify particularly high payments that are beyond the debtor's ability. If the debtor proposing small payments is making the same relative effort as a debtor who proposes large payments, their respective chances of failing to complete the plan and receiving the narrower discharge should be about equal.

A debtor who has received bankruptcy relief and is not yet eligible for a discharge under chapter 7<sup>68</sup> can receive a chapter 13 discharge. Such a debtor might be required to propose payments to unsecured creditors for two reasons. First, the legislative history discussing the unlimited access to the chapter 13 discharge indicates that zero payment plans were not contemplated.<sup>69</sup> Second, the restrictions on discharge under chapter 7 suggest an intent to prevent repeated discharges with little or no payment to unsecured creditors. It would be inconsistent to allow frequent zero payment cases under chapter 13.

Congress' lack of favor for frequent bankruptcy discharges is evident

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<sup>63</sup> 11 U.S.C. §§ 1322(a)(3), 1322(b)(1) (Supp. IV 1980).

<sup>64</sup> See *In re Carter*, 9 Bankr. 140, 143 (Bankr. N.D. Ga. 1981); Lee, *Chapter 13 nee Chapter XIII*, 53 AM. BANKR. L.J. 303, 313 (1979).

<sup>65</sup> See notes 32-33 & accompanying text *supra*.

<sup>66</sup> If a debtor proposes payments only on secured claims and fails to complete the plan, he should still be able to surrender the collateral and then modify the plan pursuant to § 1329 and receive the full discharge. 11 U.S.C. § 1329 (Supp. IV 1980). *But see* Countryman, Letter to the Editor, 85 Com. L.J. 28 (1980). Professor Countryman notes that the § 1328(a) discharge includes only debts "provided for" by the plan, and that a zero payment plan has not "provided for" unsecured debts. *Id.* While it is conceivable that a court would use this language to deny a discharge, such a result seems unlikely if a plan is completed as confirmed or as modified. Professor Countryman's observation nevertheless supports the proposition that Congress intended for plans to propose some payment to all creditors. See text accompanying notes 87-94 *infra*.

<sup>67</sup> *In re Iacovoni*, 2 Bankr. 256, 262-63 (Bankr. D. Utah 1980).

<sup>68</sup> See notes 35-36 & accompanying text *supra*.

<sup>69</sup> "Neither the interests of the debtor nor those of his creditors are served by treating conduct which would bar a discharge . . . in a liquidation case as precluding the debtor from attempting to pay off his debts, in whole or in part, under . . . a plan." BANKRUPTCY COMMISSION REPORT (pt. 2), *supra* note 39, at 208.

from the very high payments that a debtor must make under chapter 13 in order to be eligible for a subsequent discharge in a chapter 7 case filed within the six-year period.<sup>70</sup> A court could be tempted to require similarly high payments from debtors filing frequent chapter 13 petitions.<sup>71</sup> Congress declined to include such a standard in the statute, however, and there is no evidence in the legislative history that a particularly high percentage of payment on unsecured indebtedness was expected from debtors who are not eligible for a discharge under chapter 7.<sup>72</sup>

A benefits-oriented approach to chapter 13 payments imposes requirements that are essentially based on the judge's subjective view of what it takes to deserve the more complete relief of chapter 13.<sup>73</sup> The resulting unpredictability and lack of uniformity are serious weaknesses in the application of such an approach.<sup>74</sup> An evaluation of chapter 13 payments based on the relief obtained by the debtor also fails to provide a consistent basis for rejecting zero payment plans. Some benefits, such as cram down and keeping nonexempt property, do not compel larger payments than would be made by the debtor under chapter 7.<sup>75</sup>

## THE REQUIREMENT OF PAYMENTS TO UNSECURED CREDITORS

### *The Rationale for the Requirement*

Although many courts agree that all zero payment plans should be re-

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<sup>70</sup> See note 36 & accompanying text *supra*.

<sup>71</sup> If the goal is to avoid repeated discharges with little or no payment to unsecured creditors, it would be more consistent also to require high payments when a chapter 13 case is filed within six years after a nominal payment case. In such a situation a debtor would not be eligible for chapter 7 relief, see notes 34-36 & accompanying text *supra*, so a requirement of high payments would not conflict with the congressional intent to encourage debtors to choose chapter 13 over chapter 7. Imposing such a requirement without regard to the debtor's ability to pay might be unwise, however, because the debtor who is ineligible for a chapter 7 discharge is likely to make a very strong effort under chapter 13. See note 72 *infra*. If the debtor has no significant assets, creditors as a group will probably be better off receiving payments under a strong chapter 13 plan than competing among themselves for limited remedies such as garnishment.

<sup>72</sup> In practice, debtors who are ineligible for a discharge under chapter 7 may be subject to substantial pressure to propose significant payments. Since the debtor cannot convert the case to chapter 7, creditors and the court will have substantial leverage to require him to pay as much as he can afford. This also is true to some extent when the debtor takes advantage of the super discharge, since he will not want to convert to chapter 7 and remain obligated on the debt that would be discharged under chapter 13. See notes 111-12 & accompanying text *infra*. Although courts should not use good faith to impose requirements that are beyond the debtor's ability to pay, a closer scrutiny of effort seems inherent to this situation. The likelihood of a strong effort in these circumstances is a good reason for retaining the broader and more frequent discharge available to chapter 13 debtors. For a discussion of the degree of effort required of a chapter 13 debtor, see notes 99-138 & accompanying text *infra*.

<sup>73</sup> See Note, *Composition Plans*, *supra* note 10, at 670.

<sup>74</sup> *Id.*

<sup>75</sup> See text accompanying notes 59-61 *supra*.

jected, none has proposed a legitimate basis for doing so. Discussion of the payment requirements have generally ignored section 1325(a)(1), which states that a plan must "compl[y] with the provisions of this chapter . . ."<sup>76</sup> Many courts have noted that payments to creditors are an essential provision of chapter 13. *In re Iacovoni*,<sup>77</sup> for example, lists several sections referring to payments,<sup>78</sup> but derives the requirement of payments to unsecured creditors from the concept of good faith. An inquiry into good faith is unnecessary however, if the debtor proposes no payments to any creditors. Such a plan can be rejected under section 1325(a)(1) for failing to comply with the statutory provisions that mention payments.<sup>79</sup>

The provisions cited by *Iacovoni* include section 1326, titled "Payments," which refers to "the time of each *payment to creditors*"<sup>80</sup> and provides that "[e]xcept as otherwise provided . . . the trustee shall make *payments to creditors* under the plan."<sup>81</sup> *Iacovoni* also observes that to be eligible for chapter 13, a debtor must be "an individual with regular income."<sup>82</sup> The Act defines an individual with regular income as someone "whose income is sufficiently stable and regular to enable such individual to make *payments* under a plan under Chapter 13 of this title."<sup>83</sup> Subsections 1328(a) and (b) refer to completion or failure to complete "*payments* under the plan,"<sup>84</sup> and section 1329 refers to modification of the plan "before the completion of *payments*."<sup>85</sup> Section 1325(a)(6), which requires that the debtor must "be able to make all *payments* under the plan,"<sup>86</sup> indicates that a chapter 13 plan will be proposing payments.

The interpretation of section 1325(a)(1) is more difficult when a plan includes priority or secured claims, because the statute does not state whether payments must be proposed to *all* creditors. A plan that proposes payments on priority or secured claims seems to satisfy the requirement of payments, even if general unsecured creditors receive nothing.<sup>87</sup> However, the provisions referring to "payments" or "payments to creditors" can and should be interpreted to require payments to all creditors. Several considerations support this position.

If a plan includes only general unsecured claims, then section 1325(a)(1)

<sup>76</sup> 11 U.S.C. § 1325(a)(1) (Supp. IV 1980).

<sup>77</sup> 2 Bankr. 256 (Bankr. D. Utah 1980).

<sup>78</sup> *Id.* at 262.

<sup>79</sup> See *In re Scher*, [1980] 7 BANKR. CT. DEC. (CRR) 979, 989; Note, *Zero Payment Plan*, *supra* note 10, at 333 n.30.

<sup>80</sup> 11 U.S.C. § 1326(a) (Supp. IV 1980) (emphasis added).

<sup>81</sup> *Id.* § 1326(b) (emphasis added).

<sup>82</sup> *Id.* § 109(e).

<sup>83</sup> *Id.* § 101(24) (emphasis added).

<sup>84</sup> *Id.* § 1328(a)-(b) (emphasis added).

<sup>85</sup> *Id.* § 1329 (emphasis added).

<sup>86</sup> *Id.* § 1325(a)(6) (emphasis added).

<sup>87</sup> See *In re Cloutier*, 3 Bankr. 584 (Bankr. D. Colo. 1980).

requires payments on those claims. But unless payments are required on all claims, the debtor can add a secured claim to the plan and be relieved of proposing payments to unsecured creditors. A requirement of payments to general unsecured creditors should not depend on the presence or absence of other kinds of claims.

The legislative history of chapter 13 further supports a requirement that debtors propose payments to all creditors. The House Report states: "In some cases, the plan will call for full repayment. In others, it may offer creditors a percentage of their claims in full settlement."<sup>88</sup> A requirement of payments to all creditors also follows from the reference in the House and Senate reports to Congress' expectation that creditors will receive more under chapter 13 than under a liquidation.<sup>89</sup> The legislative history shows that section 1322(b)(4), which allows concurrent payment of unsecured claims with other claims, was designed to prevent debtors from completing payments to secured and priority creditors and then defaulting before any payments had been made to unsecured creditors.<sup>90</sup> Such a default was regarded as an "abuse,"<sup>91</sup> which reflects an intent to require payments to unsecured creditors. Similarly, the restrictions on the availability of the chapter XIII discharge apparently were removed in the new law because zero payment plans were not contemplated under chapter 13.<sup>92</sup>

The stated purpose of chapter 13—"to enable an individual . . . to develop and perform under a plan for the repayment of his debts"<sup>93</sup>—also suggests an intent to require payments to all creditors.

### *The Amount of Payment*

If section 1325(a)(1) requires payments to all creditors, the issue arises whether any payment, no matter how small, is acceptable. If any payment is sufficient, then the requirement becomes a meaningless formality. The House Report suggests that a plan proposing less than full payment should still constitute a "legitimate" offer;<sup>94</sup> accordingly, the payments proposed to unsecured creditors should be sufficient to be considered legitimate.

The determination of what constitutes a legitimate payment should be

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<sup>88</sup> H.R. REP. NO. 595, *supra* note 12, at 118. Later the report states that "[t]he plan may provide for full or partial payment of creditors . . ." *Id.* at 123. *See also* Note, *Legislative Solution*, *supra* note 10, at 786 (the word "creditors" in committee reports should be interpreted to mean all creditors).

<sup>89</sup> *See* note 12 & accompanying text *supra*.

<sup>90</sup> BANKRUPTCY COMMISSION REPORT (pt. 2), *supra* note 39, at 205.

<sup>91</sup> *Id.*

<sup>92</sup> *See* notes 69-70 & accompanying text *supra*.

<sup>93</sup> H.R. REP. NO. 595, *supra* note 12, at 118.

<sup>94</sup> *See* note 53 *supra*.

based on the reality that extremely small payments are insulting to creditors and unworthy of the time and expense needed to distribute them.<sup>95</sup> Although a minimum payment requirement based on these concerns will be arbitrary to some extent, a line should be drawn to establish at what point a payment is legitimate. A minimum of about five percent of unsecured indebtedness would be a reasonable payment requirement. Although five percent is probably not a substantial payment,<sup>96</sup> a higher requirement would force many debtors to choose liquidation, which is unlikely to distribute anything to unsecured creditors. A higher standard would also sacrifice too much of the flexibility intended for chapter 13.<sup>97</sup>

In addition to furthering the congressional intent that creditors receive a legitimate return in chapter 13 cases, the five percent requirement would offer practical advantages. The test is administratively convenient in allowing rejection of zero or nominal payment plans without elaborate inquiry by the court. The five percent test would also give debtors notice of a concrete threshold that must be met, providing consistent and predictable results in the gray area of low payment plans.<sup>98</sup>

### THE GOOD FAITH EFFORT REQUIREMENT OF CHAPTER 13

The requirement that all debtors must propose a payment of at least five percent of general unsecured indebtedness does not end the proposed approach to evaluating chapter 13 plans. Many debtors may easily be able to pay more than the five percent minimum, in which case additional payments should be required. A requirement of a reasonable effort to

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<sup>95</sup> See *In re Levine*, 10 Bankr. 168, 171 n.5 (Bankr. D. Mass. 1981); *In re Webb*, 3 Bankr. 61, 62 (Bankr. D. Colo. 1980); *In re Iacovoni*, 2 Bankr. 256, 268 (Bankr. D. Utah 1980).

<sup>96</sup> See note 16 & accompanying text *supra*.

<sup>97</sup> The legislative history contains isolated references to large payment plans: "[A]n overly stringent and formalized chapter XIII (wage earner plans) has discouraged overextended debtors from attempting to arrange a repayment plan under which all creditors are repaid most, if not all, of their claims over an extended period." H.R. REP. NO. 595, *supra* note 12, at 117. The weight of the legislative history, however, discussing the expansion of eligibility for chapter 13 and the need to consider the debtor's individual circumstances, indicates that large payments were not expected in all cases. See note 52 *supra*.

<sup>98</sup> The five percent minimum payment test seems incompatible with language found in the most recent committee reports accompanying proposed amendments to chapter 13. H.R. REP. NO. 1195, 96th Cong., 2nd Sess. 25 (1980), states that "the circumstances of a given case may require that the court confirm a chapter 13 plan which proposes no dividend whatever to holders of allowed unsecured claims . . ." S. REP. NO. 150, 97th Cong., 1st Sess. 19 (1981), says that "[n]o arbitrary repayment levels should be required by judges . . ." These statements, made in discussions of the good faith effort requirement, see notes 99-111 & accompanying text *infra*, are appropriate as applied to that provision. The statements should not affect the proposed interpretation of section 1325(a)(1), however, which is not related to the debtor's ability to pay. Moreover, the five percent requirement derived from section 1325(a)(1) is so low that virtually every debtor should be able to meet it, although admittedly a few debtors will have to make greater sacrifices to do so.

pay creditors is supported by comments made on the floor of Congress<sup>99</sup> as well as an interpretation of "good faith" advocated by several courts<sup>100</sup> and commentators.<sup>101</sup> Although a reasonable effort requirement can be derived from the statute in its present form,<sup>102</sup> it is likely that Congress

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<sup>99</sup> Discussions of chapter 13 in the House and Senate debates indicate that debtors were expected to make some effort: chapter 13 "preserves the debtors [sic] self-esteem by permitting him to pay his debts using his best efforts without incurring undue hardship." 124 CONG. REC. S17404 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). "We feel that if the debtor makes an effort to repay his creditors, the creditors should not be able to say that the plan does not propose to pay enough or that it does not do other things that the creditors want." 123 CONG. REC. 35,446 (1977) (remarks of Rep. Edwards). Furthermore, the House report refers to a "legitimate offer of less than full payment," see note 53 *supra*, and the Senate Report calls for a "reasonable plan for debt repayment based on that individual's exact circumstances," see note 52 *supra*.

<sup>100</sup> See, e.g., *In re Schongalla*, 4 Bankr. 360 (Bankr. D. Md. 1980); *In re Marlow*, 3 Bankr. 305, 308 (Bankr. N.D. Ill. 1980).

<sup>101</sup> See Note, *Composition Plans*, *supra* note 10; Note, *De Minimis Plans*, *supra* note 10; Note, *Filing for Personal Bankruptcy: Adoption of a "Bona Fide Effort" Test Under Chapter 13*, 14 U. MICH. J.L. REF. 321, 335 n.61 (1981) [hereinafter cited as Note, "Bona Fide Effort" Test].

<sup>102</sup> The most widely accepted analysis concludes that good faith is lacking if "there has been an abuse of the provisions, purpose, or spirit of Chapter XIII in the proposal or plan." 10 W. COLLIER, BANKRUPTCY ¶ 29.06[6] (14th ed. 1978). Stated another way, bad faith implies an intention to misuse or undermine some aspect of the statutory scheme. A debtor who does not make a reasonable effort to pay creditors is abusing the purpose of chapter 13—to allow debtors to pay their creditors under a court's supervision and protection: H.R. REP. NO. 595, *supra* note 11, at 118. The debtor who intends to pay much less than he can afford also undermines the statutory goal of reducing losses to creditors. *Id.* The requirement of a reasonable effort is therefore inherent to chapter 13's concept of good faith. This interpretation was never reached under prior law because the element of creditor approval made an inquiry into effort unnecessary. See Note, *Legislative Solution*, *supra* note 10, at 779 n.50.

Arguably the proposed amendments imposing a "bona fide effort" requirement, see note 103 *infra*, and accompanying committee reports, S. REP. NO. 150, 97th Cong., 1st Sess. 18 (1981), and H.R. REP. NO. 1195, 96th Cong., 2nd Sess. 24-25 (1980), preclude a good faith effort requirement under existing law. *E.g.*, Cyr, *supra* note 3, at 276-83. Although the committee reports indicate that Congress did not expect good faith to be a factor in evaluating chapter 13 payments, they nevertheless reinforce the notion that some degree of effort was contemplated even under existing law. S. REP. NO. 150, *supra*, H.R. REP. NO. 1195, *supra*. The *post hoc* analysis of the reports, made in the context of great confusion among courts regarding chapter 13 payment requirements, should not preclude a reasonable interpretation such as the one offered here. See Note, *Legislative Solution*, *supra* note 10, at 787-88 (ambiguity as to whether amendments are a clarification or alteration of existing law, and uncertainty of their value as authority, render them inappropriate as a basis for judicial interpretation).

Another argument against this note's interpretation of the existing good faith provision is that it imposes an objective requirement that ignores the traditional focus of the good faith inquiry—the debtor's intent and motives. See LoPucki, "Encouraging" Repayment Under Chapter 13 of the Bankruptcy Code, 18 HARV. J. LEGIS. 347, 367 (1981). Although the good faith effort inquiry focuses on objective factors, see notes 105-10 & accompanying text *infra*, it does not do violence to the traditional interpretation of good faith. A presumption that the debtor is aware of his ability to pay creditors, and therefore knows when he is paying much less than he can afford, is reasonable. A mandatory presumption or inference



will remove any doubts on this issue by enacting a provision specifically calling for a "bona fide effort" to pay creditors.<sup>103</sup> Another proposed amendment dealing with the amount of payments to be made under chapter 13 would create a standard based on the debtor's "disposable income."<sup>104</sup>

A good example of an application of the good faith effort requirement is found in *In re Schongalla*.<sup>105</sup> The debtors, a married couple with no children, claimed monthly expenses of \$400 for food, \$60 for recreation, and \$40 for books and magazines, yet proposed twelve monthly payments of \$25 on a class of unsecured claims totaling \$20,000.<sup>106</sup> The court properly rejected the plan for lack of good faith, after focusing on the

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as to the debtor's intent may be somewhat unusual, but it is necessary to provide equal treatment of debtors. Indeed, the debtor's intent must often be inferred in cases involving lack of good faith. *See In re Burns*, 6 Bankr. 286 (Bankr. D. Colo. 1980) (circumstances indicated that debtors refused to pay unsecured creditors under chapter XIII plan, selectively paid some creditors outside of plan, and then filed chapter 13 case to avoid payment of creditors); *In re Cassidy*, 401 F. Supp. 757 (E.D.N.Y. 1975) (possible finding on remand of motive to delay for foreclosure with no intent to propose and complete chapter XIII plan would be inferred from circumstances). The inferred intent of a debtor to pay less than he can afford is incompatible with the statutory goals and purposes, and therefore can legitimately be considered an abuse.

<sup>103</sup> Both houses have passed versions of a technical amendments bill which would add the bona fide effort requirement to § 1325(a)(4). S. 658, 96th Cong., 2d Sess. § 128(b), 126 CONG. REC. S15170, S15176 (daily ed. Dec. 1, 1980); S. 658, 96th Cong., 2d Sess. § 127(b), 126 CONG. REC. H11735, H11740 (daily ed. Dec. 3, 1980). The history of these provisions is discussed more extensively in *In re Scher*, [1981] 7 BANKR. CT. DEC. (CRR) 979, 991-93; Note, *Composition Plans*, *supra* note 9, at 677 n.109. The Senate has also passed another bill that contains the same change, the Bankruptcy Amendments Act of 1981, S. 863, 97th Cong., 1st Sess. § 128(b), 127 CONG. REC. S7903-04 (daily ed. July 17, 1981); *see* S. REP. NO. 150, 97th Cong., 1st Sess. 18-19 (1981). The House has planned extensive hearings on consumer bankruptcy during the second session of the 97th Congress, apparently with a view to amending the Bankruptcy Reform Act. 127 CONG. REC. H9809 (daily ed. Dec. 16, 1981).

<sup>104</sup> *Cyr*, *supra* note 3, at 286-92. The amendment, proposed by the National Bankruptcy Conference, would, among other things, add a subsection to § 1325 requiring that upon objection by an unsecured creditor the court may not confirm a plan unless it proposes to pay the debtor's projected disposable income for the three years beginning on the due date of the first payment under the plan. *Id.* "Disposable income" is defined as "all earnings and other income not reasonably necessary (a) for the support of the debtor and any dependent of the debtor . . ." *Id.* at 289. This proposal articulates the relevant inquiry more clearly than the good faith effort requirement, but it has drawbacks. First, the focus on income necessary for "support" could be interpreted to require a uniform standard of living for all chapter 13 debtors, which would be impractical. *See* text accompanying notes 114-15 *infra*. Second, unsecured creditors are not likely to react uniformly to chapter 13 plans, *see* notes 111-12 & accompanying text *infra*, and therefore the enforcement of the proposed standard should not depend totally on them. Finally, the proposal appears to require three-year plans in all cases in which an objection is made. Debtors should be allowed the flexibility to propose a shorter plan that is a stronger effort than is required. *See* text accompanying notes 108 & 127 *infra*. Under the Bankruptcy Conference amendment a proposed monthly payment could be interpreted as a binding admission of disposable income, even if it would be unduly burdensome to maintain the payment for three years.

<sup>105</sup> 4 Bankr. 360 (Bankr. D. Md. 1980).

<sup>106</sup> *Id.* at 361.

“reasonableness of the debtor’s effort to deal fairly with his creditors.”<sup>107</sup>

The level of effort required for good faith depends on several considerations which must be evaluated on a case-by-case basis. However, some degree of uniformity of approach is desirable to foster equality of treatment and predictability for debtors proposing plans. The most reliable and objective indicators of effort are the duration of the plan and the percentage of the debtor’s future income allocated to payments. To maintain a relatively consistent standard for all debtors, these two factors should be considered together. For example, if a debtor adopts a strict budget and applies all available income toward payments, then the court should not require that the plan extend for the three-year maximum. Although a debtor can voluntarily impose a very strict budget for the full three years, a *requirement* of that degree of effort would pose problems. A standard that is too strict would greatly discourage participation in chapter 13. A requirement of very great effort would also require extensive probing into the debtor’s finances, which would be administratively burdensome. Moreover, the margin for error in evaluating the debtor’s ability to complete the plan would be very slim under such a finely tuned approach, resulting in a substantial likelihood of unsuccessful performance.

A good general guideline presented in *In re Curtis*<sup>108</sup> would require most debtors to commit to their repayment plan ten percent of their take-home pay for three years. The ten percent figure is arbitrary and therefore should be used only as a starting point for analysis. Nevertheless, the guideline provides debtors with a rough idea of what is expected of them and, more particularly, discourages the tendency to “pad” the budget so that little or no excess income is available to pay creditors.<sup>109</sup> If a debtor meets the ten-percent-for-three-years test, the court should still examine the debtor’s proposed budget and require substantiation or explanation of any expenses that seem inordinately high. At the other end of the spectrum, debtors with expenses that are truly high in proportion to their income should not be required to meet the guideline.<sup>110</sup>

Although creditors have a strong interest in the amount of payments proposed under chapter 13, they may hesitate to raise objections if a plan proposes some payments but is not a good faith effort. The creditors run the risk that instead of responding to an objection with greater payments, the debtor who is challenged will exercise his right to convert to chapter 7<sup>111</sup> and possibly pay nothing. Because of the possible lack of incentive

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<sup>107</sup> *Id.* at 363.

<sup>108</sup> 2 Bankr. 43 (Bankr. W.D. Mo. 1979).

<sup>109</sup> See LoPucki, *supra* note 102, at 371-72.

<sup>110</sup> Professor LoPucki observes that the guideline essentially creates a rebuttable presumption of ability to pay. *Id.* at 369.

<sup>111</sup> 11 U.S.C. § 1307(a) (Supp. IV 1980).

for creditors to raise the issue, the bankruptcy judge must take an active role in evaluating the debtor's effort. While an emphasis on effort will be more time-consuming than a requirement of substantial payments, it will allow more debtors to participate in chapter 13 and thereby will reduce losses to creditors more effectively.<sup>112</sup> The goal of reducing losses to creditors is laudable because the savings will be passed on to consumers in the form of cheaper credit.

### APPLICATION OF THE PROPOSED APPROACH

If a debtor has satisfied the "best interests of creditors" test, the next step proposed for evaluating chapter 13 payments to unsecured creditors is the five percent test. The five percent payment requirement, derived from section 1325(a)(1), will dispose of all zero payment plans efficiently.<sup>113</sup> The final, most time-consuming step recommended for evaluating the amount of payments proposed by a plan is the good faith effort test, which in many cases will require payments that exceed five percent of unsecured indebtedness. If the debtor is proposing some payments to unsecured creditors and is making a reasonable effort, there is no justification for

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<sup>112</sup> Congress predicted that "[t]he benefit to creditors [of Chapter 13] is self-evident: their losses will be significantly less than if their debtors opt for straight bankruptcy." H.R. REP. NO. 595, *supra* note 12, at 118. Losses to creditors will be reduced more effectively by large numbers of debtors paying according to their ability than by a much smaller number making "substantial" payments. That Congress adopted this position is evident from the expansion of chapter 13 eligibility and the desire to encourage participation in chapter 13.

Congress also expected that chapter 13 would preserve a debtor's credit standing and eliminate the stigma associated with straight bankruptcy. *Id.* One scholar correctly observes that contrary to Congress' expectations the good faith effort standard will not eliminate the stigma of bankruptcy because the standard would not prohibit low payment plans and would not distinguish between debtors who have been unscrupulous or irresponsible before filing and those who have been merely unfortunate. LoPucki, *supra* note 102, at 372-83. The more serious problem is that even under a higher payment standard chapter 13 debtors are likely to experience some stigma, *see id.* at 378 n.120, because from a creditor's perspective any effort that is less than full payment with interest should affect the debtor's credit worthiness. The unlimited access to the chapter 13 discharge in particular may make creditors fearful that a debtor who has taken advantage of chapter 13 will do so again.

Congress should deal with this problem realistically by requiring credit reporting agencies to include specific information about chapter 13 cases, such as the percentage of indebtedness that the debtor proposed to pay and the debtor's subsequent success or failure in performing under the plan. This information can be supplied easily by bankruptcy courts. *Id.* If creditors are fully informed, standards for evaluating credit worthiness of chapter 13 debtors will inevitably emerge and will provide notice to debtors of the effect of various levels of performance.

For debtors who are unable to achieve repayment levels that will help their credit rating, other incentives are needed to encourage participation in chapter 13. The proposal to provide chapter 7 debtors the benefits of chapter 13 without a good faith effort requirement, LoPucki, *supra*, at 387, would eliminate the incentives for many debtors to choose chapter 13 and therefore should not be adopted.

<sup>113</sup> See notes 76-98 & accompanying text *supra*.

further payment requirements based on chapter 13 benefits. Under the proposed approach the benefits of chapter 13 should have no bearing on the confirmation of a plan.

By giving substantial weight to the percentage of income committed to repaying creditors, the proposed evaluation of effort does not attempt to impose the same standard of living on all chapter 13 debtors.<sup>114</sup> If all debtors are forced to live within the same budget, the sacrifice required of higher income debtors would be unacceptable to them. In particular, debtors should not have to move to a cheaper house or apartment if their housing expense is reasonable in relation to their income. It would be similarly unworkable to limit all debtors to the same allowance for automobile payments, although some debtors clearly will have to give up cars that are burdensome or unnecessary.<sup>115</sup>

For many expense items, however, such as food, clothing, and recreation, debtors are not locked into fixed payments; closer scrutiny of these items is appropriate and is likely to result in greater sacrifices for debtors with higher incomes. For example, no matter how great a debtor's income is, a plan that provides for a high food expense to accommodate frequent dining out should not be confirmed.

The *Report of the Commission on the Bankruptcy Laws of the United States* states that chapter 13 debtors should not be required to apply nonexempt assets toward payment of debts "except insofar as such application may be deemed necessary . . . to meet the statutory standards of the 'best interests of creditors' and 'good faith.'"<sup>116</sup> If the debtor's income alone is insufficient to make payments required by the "best interests" test or the proposed five percent test, then the debtor will have to surrender enough nonexempt assets to meet the tests. But a further requirement of liquidation based on good faith should be imposed sparingly; otherwise, debtors are likely to choose chapter 7, under which their assets will be liquidated anyway without sacrificing future income. Only if the debtor's property is extensive should a good faith effort require liquidation of nonexempt assets.<sup>117</sup>

Generally, cram down of secured creditors should be liberally allowed,

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<sup>114</sup> See LoPucki, *supra* note 102, at 363-69.

<sup>115</sup> See note 118 & accompanying text *infra*.

<sup>116</sup> BANKRUPTCY COMMISSION REPORT (pt. 1), *supra* note 39, at 164.

<sup>117</sup> One commentator suggests that debtors with substantial non-exempt property will file under chapter 11 to keep the property, LoPucki, *supra* note 102, at 363-64, yet acknowledges that courts will be able to reject such chapter 11 plans. *Id.* at 364-65.

Professor LoPucki also cites inequities that would result if chapter 13 debtors in states with liberal exemption laws were allowed to keep large amounts of exempt property. *Id.* at 367-68. A good faith effort standard should require such debtors to apply some exempt property toward payment of creditors, which unfortunately would cause those debtors to choose chapter 7. *Id.* at 386. This problem is caused by inequalities in state exemption laws, however, not by any shortcomings of chapter 13.

but problems may arise in some cases. The cram down option may require so much future income that the debtor is unable to satisfy the five percent requirement for payments on unsecured indebtedness. In such cases the debtor will have to surrender the collateral to the secured creditor. The good faith effort standard may also restrict the use of cram down. If the payments necessary to retain the collateral are too burdensome, or the property is an unnecessary luxury, cram down would be unfair to unsecured creditors who would be paid more if the property were surrendered.<sup>118</sup>

A few cases help illustrate the application of the proposed approach to payments on unsecured claims. A good example of a plan that was properly rejected, but for the wrong reason, can be found in *In re Marsch*.<sup>119</sup> The court in *Marsch* found that the plan, which proposed a twenty-five percent payment of unsecured claims, was deficient because two-thirds of the unsecured indebtedness was made up of student loans that would be nondischargeable under chapter 7.<sup>120</sup> The debtor received take home pay of \$980 a month, but proposed to pay only \$45 a month into the plan.<sup>121</sup> The court should not have considered the nature of the debts to be discharged; instead, the plan should have been rejected for lack of a good faith effort.

Two similar cases in which the length of the plan was at issue illustrate the lack of uniformity regarding good faith. In *In re Curtis*<sup>122</sup> the debtors were a married couple who had one child and were expecting another. Their net income was \$783 a month and they proposed payments of \$75 a month for eighteen months.<sup>123</sup> The debtors in *In re Hall*<sup>124</sup> had two children and a net monthly income of \$676. They proposed to pay \$75 a month for fifteen months.<sup>125</sup> Both couples met the threshold five percent test advocated by this note.<sup>126</sup> Although they did not propose to pay ten percent of their income for the full three years, both couples were making a very strong effort in view of their limited incomes and high expenses. Under these circumstances the good faith effort test was

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<sup>118</sup> See *In re Granger*, 7 Bankr. 14 (Bankr. S.D. Ohio 1980); *In re Patterson*, 4 Bankr. 239 (Bankr. C.D. Cal. 1980); S. REP. NO. 150, 97th Cong., 1st Sess. 19 (1981) ("There should be no such expenses as the purchase of new cars or for that matter continuing to make payments on a nearly new car at the expense of unsecured creditors under the plan."); Note, *De Minimis Plans*, *supra* note 10, at 616-17; Note, "Bona Fide Effort" Test, *supra* note 101, at 339-40.

<sup>119</sup> 11 Bankr. 514 (Bankr. D.R.I. 1981).

<sup>120</sup> *Id.* at 515.

<sup>121</sup> *Id.*

<sup>122</sup> 2 Bankr. 43 (Bankr. W.D. Mo. 1979).

<sup>123</sup> *Id.* at 44.

<sup>124</sup> 4 Bankr. 341 (Bankr. E.D. Va. 1980).

<sup>125</sup> *Id.* at 341.

<sup>126</sup> The plan in *Hall* would have yielded a 6% dividend to unsecured creditors, *id.* at 342, and the *Curtis* plan proposed to pay 10% of unsecured indebtedness, 2 Bankr. at 43.

satisfied, although the plan was confirmed in *Curtis* and rejected for lack of good faith in *Hall*.

The couples in *Curtis* and *Hall* elected to make an extremely strong effort for a period shorter than the three-year maximum. To require such an effort for three years would be unduly harsh. The debtors could have satisfied the good faith effort test by proposing significantly lower payments for the full thirty-six months, but if the deferred payments were discounted to present value, the net result for creditors would be similar.<sup>127</sup>

Two cases in which low payment plans were confirmed illustrate the application of the good faith effort requirement and the five percent test. Because of her criminal record, the debtor in *In re Keckler*<sup>128</sup> could only find part-time work for her father earning \$215 a month. Her plan proposed payments of \$15 a month for three years, yielding a five percent dividend to unsecured creditors.<sup>129</sup> The case revealed no reason why the debtor could not pay at least ten percent of her net income, particularly since she was living with her parents and had low expenses. The plan should have been rejected for lack of a good faith effort.

In *In re Dills*<sup>130</sup> the debtor's net income was \$97 a week, and he proposed to pay creditors \$10 a week for one year. The payments constituted a reasonable effort in view of the debtor's contributions to family expenses. The dividend to unsecured creditors under the plan, however, was only one percent.<sup>131</sup> Accordingly, the debtor should have been required to continue the payments for an additional seven or eight months to meet the five percent test.

The extent to which a good faith effort requires a debtor to change his style of living is dealt with in *In re Manning*.<sup>132</sup> The debtors in *Manning* were a married couple with three children who apparently were in college. The children did not work. Although their net monthly income was about \$2,600, the debtors proposed to pay \$80 a month for more than four years.<sup>133</sup> No payments to unsecured creditors were proposed. The debtors claimed a monthly food expense of \$754, explaining that the entire family required a special diet.<sup>134</sup> A transportation expense of more than \$300 was claimed, even though secured creditors on two automobiles were provided for separately.<sup>135</sup> It is difficult to avoid the conclusion that

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<sup>127</sup> For example, if the debtors in *Hall* paid \$40 a month for three years, the present value of the payments would be comparable to that of the payments actually proposed, assuming an 18% interest rate.

<sup>128</sup> 3 Bankr. 155 (Bankr. N.D. Ohio 1980).

<sup>129</sup> *Id.* at 156.

<sup>130</sup> [1980] 6 BANKR. CT. DEC. (CRR) 800.

<sup>131</sup> *Id.* at 801.

<sup>132</sup> 5 Bankr. 387 (Bankr. W.D.N.Y. 1980).

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* at 388.

<sup>135</sup> *Id.* at 387-88.

the claimed expenses were either exaggerated or unnecessary; consequently, the debtors' failure to meet the preliminary ten-percent-for-three-years test is not justified. The five percent test provides an even clearer basis for rejecting the plan.

The court in *Manning* found that to satisfy the good faith requirement the debtors should rent half of their house, which was a duplex, and apply the rental income to their plan.<sup>136</sup> The court would have been correct in suggesting this measure as a means to meet the five percent requirement. But only rarely should good faith require debtors to change their lifestyle so radically.<sup>137</sup> The debtors' house in *Manning* was not an unreasonable burden in view of their income,<sup>138</sup> nor was it an unnecessary luxury. The court should have focused its analysis on the unusual expenses claimed by the debtors. The result was correct, however, because the court exposed the lack of merit in the debtors' claim that they were a hardship case.

### CONCLUSION

Many courts interpreting the Bankruptcy Reform Act of 1978 have correctly required that chapter 13 plans propose payments to unsecured creditors, but the decisions are based largely on an unsound view of the relationship between good faith and the special benefits of chapter 13. Evaluating plans on the basis of the debtor's use of chapter 13 benefits has sometimes resulted in unreasonable standards that undermine the congressional intent to attract more debtors to chapter 13 and to reduce losses to creditors.<sup>139</sup>

A legitimate statutory justification is available for rejecting zero payment plans under chapter 13. Section 1325(a)(1) of chapter 13 should be interpreted to require that debtors propose to pay at least five percent of their unsecured indebtedness. To satisfy the requirement of good faith found in section 1325(a)(3), a chapter 13 plan should represent a reasonable effort by the debtor to pay unsecured creditors. Bankruptcy courts should evaluate effort initially in terms of the percentage of the debtor's income proposed as payments, using the *Curtis* guideline of ten percent for three years. Higher payments should be required, however, if a plan that meets the guideline includes expenses that are not reasonable, and lower payments should be allowed if the court determines that the debtor's living expenses are unusually high in proportion to his income.

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<sup>136</sup> *Id.* at 388.

<sup>137</sup> See text accompanying notes 114-15 *supra*.

<sup>138</sup> The debtors' house expense of \$681 a month took about 26% of their income. 5 Bankr. at 387-88.

<sup>139</sup> See note 50 *supra*.