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COMMENTS

THE UNCERTAIN STATUS OF SECURED CREDITORS UNDER CHAPTER XIII OF THE BANKRUPTCY ACT

INTRODUCTION

The two forms of relief for financially distressed wage earners under the current Federal Bankruptcy Act are straight bankruptcy¹ and a Wage Earner Plan as provided for under Chapter XIII.² Prior to 1938 only straight bankruptcy was available to the insolvent debtor seeking relief from his creditors. This procedure was recognizably traumatic for the debtor who was discharged from his debts only by surrendering his assets and being stigmatized as a bankrupt.³ Moreover, straight bankruptcy was generally an unsatisfactory solution for the creditors, who seldom received more than a fraction of their claims.⁴

Chapter XIII of the Bankruptcy Act was adopted to ameliorate the harsh results and unsatisfactory solutions of straight bankruptcy.⁵ Through a Wage Earner Plan, a debtor is permitted to resolve his financial problems with a judicially approved and supervised plan providing for periodic payments to

1. Bankruptcy Act Chapter I-VII, 11 U.S.C. §§ 1-74 (1973). [Hereinafter all citations will be to the Bankruptcy Act only.]

2. Bankruptcy Act §§ 601-86 (1973).

3. *Perry v. Commerce Loan Co.*, 383 U.S. 392 (1966); see also Note, *The Wage Earner Plan—A Superior Alternative to Straight Bankruptcy*, 9 UTAH L. REV. 730 (1965); Allgood, *Operation of the Wage Earners' Plan in the Northern District of Alabama*, 14 RUTGERS L. REV. 578 (1960).

4. See note 3 *supra*.

5. H. R. REP. NO. 1409, 75th Cong., 1st Sess. 52-55 (1937). Congress has reaffirmed its legislative purpose in amendments to Chapter XIII adopted since the original enactment. A report to the House of Representatives stated:

[C]hapter XIII provides a highly desirable method for dealing with the financial difficulties of individuals. It creates an equitable and feasible way for the honest and conscientious debtor to pay off his debts rather than having them discharged in bankruptcy. The power of the court to change the amount and maturity of installment payments without affecting the aggregate amount of such payments makes Chapter XIII particularly applicable to the present-day financial problems generated by heavy installment buying.

H.R. REP. NO. 193, 86th Cong., 1st Sess. 2 (1959).

The Senate report agreed:

We think there can be no doubt . . . that a procedure by which a debtor who is financially involved and unable to meet his debts as they mature, over a period of time, works out of his involvement and pays his debts in full is good for his creditors and good for him. S. REP. NO. 179, 86th Cong., 1st Sess. 2 (1959), 1959 U.S. CODE CONG. AND ADMIN. NEWS, 1446, 1447.

creditors out of future earnings.⁶ The plan may provide for an extension or composition of the debtor's outstanding obligations to achieve the desired relief.⁷ If the plan is successfully completed, creditors receive full payment or some approximation of full payment, while the debtor retains his assets, his good name and hopefully is rehabilitated in his spending habits.

A debtor filing a Wage Earner Plan under Chapter XIII must submit a verified petition stating that he is insolvent or unable to meet his obligations as they become due.⁸ He must also prepare a plan which provides for the extension or composition of his debts.⁹ The plan must deal with all unsecured claims generally¹⁰ and may deal with secured claims severally,¹¹ except

6. In noting this characteristic, one writer pointed out: Interestingly enough, the wage earner plans of Chapter XIII are one of the few presently available methods envisioning the payment of past obligations via promises to pay out of future earnings (often the basic assumption behind the original creation of the debt). Comment, *Debtors' Dilemma: Status of the Secured Creditor Under Chapter XIII of the Bankruptcy Act*, 4 U.C.D.L. REV. 277, 278 (1971) (footnotes omitted).

7. Bankruptcy Act § 623 (1973). Section 623 states: A petition filed under this chapter shall state that . . . [the debtor] desires to effect a composition or an extension, or both, out of his future earnings or wages. An extension permits a debtor to extend the time period for payment, but requires that the debts be paid in full. The extended time period is ordinarily not more than three years. On the other hand, a composition of debts reduces the payments made to less than 100% on each debt owed. Most wage earner plans are extension plans. In the Northern District of Illinois, for example, 98% of all wage earner plans filed in 1974 were extension plans. This figure was compiled from, United States District Court for the Northern District of Illinois, Annual Report (1974).

8. Bankruptcy Act § 623 (1973). An insolvent debtor is a person whose debts exceed the total value of his assets. Bankruptcy Act § 1(19) (1973). Chapter XIII, however, is available to both debtors who are insolvent and to those who allege that they are unable to pay their debts as they mature. Inability to pay debts as they mature does not necessarily mean that one is insolvent. A debtor in Chapter XIII may have assets the value of which greatly exceeds the amount owed. In such situations straight bankruptcy is not practical. The debtor will be in a much better position if he voluntarily disposes of some assets to pay creditors rather than go through the embarrassment of bankruptcy.

9. See note 7 *supra*. The procedural aspects of Chapter XIII are governed by the Chapter XIII Rules of Procedure adopted in 1973. Rule 13-201 states:

If a plan is not filed with the petition it shall be filed within 10 days thereafter and such time shall not be further extended except for cause shown

[Hereinafter the Chapter XIII Rules shall be cited by number only.] These rules were approved by the Judicial Conference of the United States and were prescribed pursuant to 28 U.S.C. § 2075, to govern the forms of process, writs, pleadings, motions and the practice and procedure under Chapter XIII of the Bankruptcy Act. These rules supersede laws, including provisions of the Bankruptcy Act, in conflict with them. However, like other rules of court authorized to be prescribed by the Supreme Court under the enabling provisions of Chapter 131 of the Judicial Code, they "shall not abridge, enlarge, or modify any substantive right" set forth in the Bankruptcy Act.

10. Bankruptcy Act § 646(1) (1973): "A plan under this chapter—

those which are secured by real property.¹² Notice of the proposed plan with the date for the first meeting of creditors is then sent to all known claimants of the debtor.¹³ At the first meeting the court allows or disallows the creditors' claims,¹⁴ and determines which claims are secured,¹⁵ partially secured¹⁶ or

(1) shall include provisions dealing with unsecured debts generally, upon any terms."

11. *Id.* § 646(2): "A plan under this chapter—(2) may include provisions dealing with secured claims severally, upon any terms."

12. *Id.* § 606(1). This section provides that "claims" secured by real estate shall not be included in the definition of "claims" recognizable under Chapter XIII. Further, the term "creditor" shall mean the holder of any claim. *Id.* § 606(2).

13. Rule 13-204(a) (1) provides:

(a) *First Meeting.*

(1) *Date and Place.* Promptly after the filing of a plan the court shall call a first meeting of creditors, but if there is an application or motion to dismiss or to convert to bankruptcy under Rule 13-112, or an appeal from or a motion to vacate an order entered under that rule, the court may delay fixing a date for such meeting. A copy or summary of the last filed plan and a form of proof of claim containing provision for acceptance or rejection of the plan shall accompany the notice of the meeting. The notice shall state that any secured claim not filed on or before the first date set for the first meeting of creditors or within such extended time as the court may fix will not be treated as a secured claim for purposes of voting and distribution and that any creditor filing a claim who has not filed a written acceptance or rejection of the plan pursuant to Rule 13-202 prior to the conclusion of the first meeting of creditors shall be deemed to have accepted the plan. The meeting may be held at a regular place for holding court or at any other place within the district more convenient for the parties in interest.

14. Rule 13-204(a) (2) provides:

(2) *Agenda.* The bankruptcy judge shall preside over the transaction of all business at the first meeting of creditors, including the examination of the debtor. He shall, when necessary, allow and disallow claims, determine which claims are unsecured and which are secured and to what extent, which claims have voted for and against acceptance of the plan, and may rule on confirmation of the plan pursuant to Rule 13-213 if notice of the hearing on confirmation was included in the notice of the meeting.

The creditor sets out his claim by filing a Proof of Claim with the court. Rule 13-301 states:

(a) *Form and Content; Who May Execute.* A proof of claim shall consist of a statement in writing setting forth a creditor's claim and setting forth facts showing that such claim is free from any charge forbidden by applicable law. Except as provided in Rules 13-303 and 13-304, a proof of claim shall be executed by the creditor or by his duly authorized agent. Except as provided in Rule 13-303, a proof of claim shall conform substantially to Official Form No. 13-9.

(b) *Evidentiary Effect.* A proof of claim executed and filed in accordance with these rules shall constitute prima facie evidence of the validity and amount of the claim, but any creditor may be required by the court to establish by affidavit or in such other manner as the court may require before allowance of the claim, that it is free from any charge forbidden by applicable law.

15. Rule 13-302(c): "If a security interest is claimed, the proof of claim shall be accompanied by satisfactory evidence that the security interest has been perfected." Further, Rule 13-302(e) (1) provides:

A secured claim, whether or not listed in the Chapter XIII Statement, must be filed on or before the first date set for the first meeting of creditors in the Chapter XIII case unless the court, on application before the expiration of that time and for cause shown, shall grant a reasonable, fixed extension of time. *Any claim not*

unsecured¹⁷ for purposes of the Chapter XIII proceeding. Once the status of creditors has been determined, a vote is taken for or against acceptance of the plan.¹⁸ If accepted by all creditors, the plan will usually be confirmed by the court,¹⁹ at which time it becomes binding upon the parties.²⁰ However, if less than all creditors accept the plan, it can only be confirmed by the court if a majority of the unsecured creditors who are "affected"

property filed by the creditor within such time shall not be treated as a secured claim for purposes of voting and distribution in the Chapter XIII case. (Emphasis added).

16. Rule 13-307(d) requires the valuation of security:

(d) *Secured Claims.* If a secured creditor files a claim, the value of the security interest held by him as collateral for his claim shall be determined by the court. The claim shall be allowed as a secured claim to the extent of the value so determined and as an unsecured claim to the extent it is enforceable for any excess of the claim over such value. For the purposes of this subdivision the court may appoint an appraiser in the manner specified by and subject to the limitations of Bankruptcy Rule 606.

The importance of this section will be explored in detail later. See notes 63-77 and accompanying text, *infra*.

17. Rule 13-302(e)(2):

(2) *Unsecured Claims.* Unsecured claims, whether or not listed in the Chapter XIII Statement, must be filed within 6 months after the first date set for the first meeting of creditors in the Chapter XIII case, except as follows:

(A) On application before the expiration of such period and for cause shown, the court may grant a reasonable, fixed extension of time for the filing of a claim by the United States, a state, or a subdivision thereof.

(B) In the interest of justice the court may grant an infant or incompetent person without a guardian up to an additional 6 months for filing a claim.

(C) A claim which arises in favor of a person or becomes allowable because of a judgment for the recovery of money or property from such person or because of a judgment denying or avoiding a person's interest in property may be filed within 30 days after such judgment becomes final, but if the judgment imposes a liability which is not satisfied, or a duty which is not performed, within such period or such further time as the court may permit, the claim shall not be allowed.

18. Rule 13-202. Generally, if a creditor does not file a written rejection prior to the conclusion of the first meeting of creditors, he shall be deemed to have accepted the plan.

19. Bankruptcy Act § 651 (1973) provides:

A plan which at the meeting of creditors, as provided in section 633 of this Act, has been accepted in writing by all creditors affected thereby, whether or not their claims have been proved, shall be confirmed by the court when the debtor shall have made the deposit required under this chapter and under the plan, and if the court is satisfied that the plan and its acceptance are in good faith and have not been made or procured by any means, promises or acts forbidden by this Act.

Section 651 has been revised by Rule 13-213 which requires a hearing prior to confirmation even though all affected creditors have accepted the plan.

20. Bankruptcy Act § 657 (1973):

Upon confirmation of a plan, the plan and its provisions shall be binding upon the debtor and upon all creditors of the debtor, whether or not they are affected by the plan or have accepted it or have filed their claims, and whether or not their claims have been scheduled or allowed or are allowable.

by the plan approve it, and if every secured creditor whose claim is "dealt with" also consents.²¹

Problems with approval of a Chapter XIII plan arise when a secured creditor refuses to consent to confirmation. The court must then determine whether the creditor has been "dealt with" by the proposed plan. The "dealt with" clause has been construed by the judiciary in a variety of ways, and the manner in which the phrase is interpreted often determines the rights, status and power of the non-assenting secured creditor.²² Since secured creditors are usually present in contemporary Chapter XIII proceedings,²³ the manner in which the courts construe their rights and powers often determines whether a plan will succeed or fail and ultimately whether the Chapter will fulfill its purpose of providing an alternative to straight bankruptcy.²⁴

Cases considering the issue of the proper role of the non-assenting secured creditor and whether he has been "dealt with" by a plan have left a mass of conflicting opinions. Some decisions result in secured creditors having virtually unlimited control over the confirmation of a debtor's plan, while others have attempted to arrive at equitable results by invoking their power to enjoin non-assenting creditors from foreclosing on their security, apparently ignoring the "dealt with" clause of Chapter XIII. Further, decisions are found which juggle the statutory

21. *Id.* § 652:

If a plan has not been so accepted, an application for the confirmation of the plan may be filed with the court within such time as the court shall have fixed in the notice of such meeting, or at or after such meeting and after, but not before—

(1) it has been accepted in writing, if unsecured creditors are affected by the plan, by a majority in number of all such creditors whose claims have been proved and allowed before the conclusion of the meeting, which number shall represent a majority in amount of such claims, and by the secured creditors whose claims are dealt with by the plan; and

(2) the debtor has made the deposit of moneys required of him under this chapter and under the plan.

Rule 13-213 revises § 652 by eliminating the requirement of a formal application for confirmation.

22. Some courts have effectively limited whatever power the non-assenting secured creditor may have by enjoining such creditors from acting. See note 57 and accompanying text, *infra*.

The use of the court's injunctive power may today be a more important judicial weapon in limiting non-assenting secured creditors' powers than any interpretation of the "dealt with" clause. With the adoption in 1973 of the Chapter XIII Rules of Procedure, the filing of a Chapter XIII petition operates as an automatic stay of actions and lien enforcement by creditors against the debtor. Rule 13-401(a). The courts thus have the power to prevent reclamation of security by merely refusing to lift the pre-existing injunction. Prior to the adoption of the Rules, the courts had the power to issue injunctions only for cause (Bankruptcy Act § 614) and this may have limited courts from using it in the past.

23. See Seidman, *The Plight of the Secured Creditors in Chapter XI*, 80 *COM. L.J.* 343, 344 (1975).

24. It must be noted that there are few appeals from any decision

provisions and language to arrive at results deemed just by the courts.

What remains is confusion. Nowhere is there an authoritative pronouncement of the legal and equitable rights of secured creditors in Chapter XIII proceedings. The source of this confusion is found in the imprecise language of Chapter XIII, which has been referred to as the most poorly drafted section of the Bankruptcy Act.²⁵ At this point, a review of the cases interpreting the ambiguous language of Chapter XIII, and how such interpretations affect the administration of the Chapter, is necessary in order to determine the proper status of secured creditors with respect to Wage Earner Plans.

JUDICIAL INTERPRETATIONS OF SECURED CREDITORS UNDER CHAPTER XIII

The cases concerning Chapter XIII secured creditors deal mainly with two issues: whether a plan can be confirmed over the objection of a secured creditor, and, if confirmed, whether the court can enjoin the creditor from reclaiming his security. These issues are often so interconnected in the cases as to make separate discussion impractical. However, since a plan cannot be confirmed if not accepted by every creditor secured by an interest in personal property whose claim is "dealt with,"²⁶ the initial question is whether the non-assenting secured creditor has in fact been "dealt with" by the proposed plan. Several views have evolved concerning this issue. The ultimate effect of the view adopted by a particular court is often determinative of whether Chapter XIII will be a viable alternative to straight bankruptcy.

One line of decisions has virtually foreclosed a debtor from taking advantage of Chapter XIII when non-assenting secured creditors are present. These decisions hold that a secured creditor is "dealt with" if his contract rights are in any way changed or if his claim is ignored. In the case of *In re O'Dell*,²⁷ the

of the Chapter XIII court. The amount of any secured or unsecured claim is generally small when compared with the potential costs of an appeal. Therefore, both debtors and creditors find it advantageous to arrive at some equitable settlement rather than press their legal rights. The "proper" role of the secured creditor in Chapter XIII cases must be viewed with this general principle in mind.

The potential problem which exists, however, is that the various jurisdictions may well be following the scant case law which has evolved in their districts. If this is so, then the "law" on secured creditors' rights in Chapter XIII depends on where one lives and necessarily denotes the bargaining power which the parties have. This problem should be alleviated by congressional action. See p. 394-95 *infra*.

25. Countryman, *New Rules for Chapter XIII*, 46 AM. BANKR. L.J. 129 (1972).

26. Bankruptcy Act § 652 (1973).

27. 198 F. Supp. 389 (D. Kan. 1961).

debtor proposed a plan which provided for payment of \$37 per week to secured creditors whose contracts called for payments of \$38 per week. The referee confirmed the plan, but on appeal it was held that confirmation should have been denied on the grounds that a wage earner plan must provide for *full* payment to *all* secured creditors according to the terms of their contracts before a plan could be confirmed.²⁸ By way of dictum the court announced that even if a debtor expressly excluded a secured creditor from the actual terms of a plan, the creditor would nonetheless be deemed "dealt with."²⁹ In short, this holding stands for the position that all secured creditors must either accept a plan, be fully provided for, or be allowed to reclaim their collateral as a prerequisite to confirmation.

The *O'Dell* court in the later case of *In re Copes*,³⁰ was faced with a plan which provided for payments of \$27 per month in lieu of \$45 per month as required by the secured creditor's contract.³¹ The *Copes* court reaffirmed its earlier position notwithstanding the trial court's finding that reclamation of the collateral would interfere with the plan's success. The court held that "a secured creditor who rejects a plan is entitled either to his contract benefits or the return of his security."³² Apparently, the creditor's contract rights were deemed more important than the otherwise viable Chapter XIII plan.

The reasoning in *O'Dell* was carried to its logical conclusion by an Ohio district court in *In re Pappas*.³³ In *Pappas*, a partially secured creditor³⁴ appealed from the referee's order con-

28. *Id.* at 391. The court stated:

A plan . . . which does not provide for assumption of executory contracts by the trustee or otherwise make provision for the payment of the claims of secured creditors according to the terms of the instrument creating the debt, does deal with such claims. A plan without such provisions should not be confirmed unless accepted by the secured creditors.

29. The court reasoned that dissenting secured creditors would have been subject to the potential injunctive power of the bankruptcy court and thus could have been prevented from enforcing their secured liens. In disagreeing with this logic, one court noted that:

What the [*O'Dell*] court was saying was that because a general provision in the Act might empower the referee to prevent such recourse, 'realistically' the claim was dealt with in the plan. Not only did this produce the unfortunate, and we believe unnecessary, holding that no plan can be confirmed over the objection of a secured creditor who is not fully recognized in his pursuit of income as well as against the security, but it did so by the paradoxical reasoning that a claim was 'dealt with by a plan' precisely because it was not dealt with.

Cheatham v. Universal C.I.T. Credit Corp., 390 F.2d 234, 238 n.5 (1st Cir. 1968). The potential injunctive power which the *O'Dell* court feared is today automatic. See note 22 *supra*.

30. 206 F. Supp. 329 (D. Kan. 1962).

31. *Id.*

32. *Id.* at 331.

33. 216 F. Supp. 819 (S.D. Ohio 1962).

34. The fact that the creditor was partially secured would have

firming the debtor's plan. The order had specifically stated that the particular creditor was not to be dealt with by the plan.³⁵ Further, the referee granted the creditor leave to file a reclamation petition, and in the interim provided that "said creditor shall participate as a secured creditor . . . in the funds paid by the debtor into the plan until a determination on the reclamation proceedings."³⁶ On appeal, the district court concluded that the creditor was forced to become an involuntary participant because the periodic payments under the plan would have been insufficient to meet the full monthly installments called for in the contractual agreement.³⁷ Acceptance of the plan by the secured creditor was held a prerequisite to confirmation because the lesser periodic payments were deemed to constitute a modification of the creditor's contract rights.³⁸ The creditor was thus "dealt with," and since he had not accepted the plan, the order of confirmation was reversed.

The approach taken in the *O'Dell* line of cases has severely restricted the use of the wage earner plan. By requiring that all secured creditors assent to a plan as a condition of confirmation, or that any dissenters be allowed to enforce their security interests and reclaim their collateral, such creditors were placed in a strong bargaining position. In effect, they could veto any plan that did not guarantee the identical rights they enjoyed prior to the debtor seeking relief in a Wage Earner Plan.³⁹

All other courts having considered the issue have rejected the *O'Dell* conclusion that a creditor excluded from a plan may have a say in the confirmation.⁴⁰ The principal effect of this reasoning is to permit confirmation of plans which have excluded dissenting secured creditors from their operation. This approach gives substance to the permissive language of Section 646 of the Act which states that a plan "may include provisions dealing

profoundly influenced the outcome of this case had the Chapter XIII Rules been in effect at the time of decision. See notes 63-77 and accompanying text, *infra*.

35. *In re Pappas*, 216 F. Supp. 819, 821 (S.D. Ohio 1962).

36. *Id.*

37. *Id.* at 822.

38. *Id.*

39. The following courts have followed this position: *Terry v. Colonial Stores Employee's Credit Union*, 411 F.2d 553 (5th Cir. 1969); *Interstate Finance Corp. v. Scroggum*, 265 F.2d 889 (6th Cir. 1959); *In re Rutledge*, 277 F. Supp. 933 (E.D. Ark 1967); *In re Pappas*, 216 F. Supp. 819 (S.D. Ohio 1962); *In re O'Dell*, 198 F. Supp. 389 (D. Kan. 1961). See also 63 MICH. L. REV. 1449 (1965).

40. See, e.g., *Cheetham v. Universal C.I.T. Credit Corp.*, 390 F.2d 234 (1st Cir. 1968); *In re Clevenger*, 282 F.2d 756 (7th Cir. 1960). See generally Poulos, *The Secured Creditor in Wage Earner Proceedings: Dream Versus Reality*, 44 REF. J. 68 (1970); Comment, *Debtors' Dilemma: Status of the Secured Creditor Under Chapter XIII of the Bankruptcy Act*, 4 U.C.D.L. REV. 277 (1971).

with secured debts",⁴¹ and represents a more reasonable construction of the Chapter XIII language. Although these courts are in agreement on the proposition that only secured creditors named in the plan may object to confirmation, they differ as to whether such creditors have been "dealt with." One line of decisions requires named secured creditors to receive full contractual payments, while the other permits slight modification of their contract rights.

The courts which follow the first line of reasoning have consistently held that secured creditors are "dealt with" whenever a plan proposes to modify contractual rights. Modification of contract rights includes both changes in rates of payment⁴² and failure to provide for the payment of arrears within specific time periods.⁴³ The practical effect of these decisions is to permit referees to confirm plans over the objection of secured creditors who have been fully provided for. Moreover, if the creditor has been excluded from the proposed plan, the referee can invoke his injunctive power and stay reclamation proceedings upon making certain findings. Generally, the court must find that the debtor has an equity in the property or that it is necessary to his performance under the plan, that the creditor's security is not impaired by the stay, and that the stay is conditioned upon appropriate provisions in the plan for curing defaults and maintaining payments on the secured claim.⁴⁴

Although this line of cases is more consistent with the congressional intent⁴⁵ than the *O'Dell* line, it is not without problems. These problems can best be illustrated by an example founded upon current economic realities. Assume that *D*, a wage earner, is employed at a net salary of \$450 per month, and that his expenses for food, rent and clothing are \$300 per month. *D* owes \$800 on a debt secured by his automobile, payable to creditor *C* in monthly installments of \$80. *D* uses the automobile to drive to and from work. *D* also has other unsecured debts aggregating \$1,200, which require payment of \$50 per month. His

41. Bankruptcy Act § 646 (1973) (emphasis added).

42. See, e.g., *In re Clevenger*, 282 F.2d 756 (7th Cir. 1960); cf. *Cheetam v. Universal C.I.T. Credit Corp.*, 390 F.2d 234, 238 n.6 (1st Cir. 1968).

43. See, e.g., *In re Rutledge*, 277 F. Supp. 933 (E.D. Ark. 1967).

44. *Id.* The injunctive power may also be exercised by the court in Chapter XIII proceedings to stay foreclosure of claims secured by interests in real property if the same factors are present. Thus, even though § 606(1), (4) and § 646(2) forbid a plan from dealing with claims secured by real property, it has been recognized that the term "property" as used in both § 611 and § 614 includes such interests, and therefore the court has the power to stay foreclosures of liens on real property. *Hallenbeck v. Penn Mutual Life Ins. Co.*, 323 F.2d 566 (4th Cir. 1963); *In re Garrett*, 203 F. Supp. 459 (N.D. Ala. 1962); *In re Howard*, 344 F. Supp. 1138 (E.D. Ark. 1971).

45. See note 5 and accompanying text *supra*.

total secured and unsecured obligations therefore are \$130 per month. Assume further that *D* loses his job and finds new employment one month later at \$350 per month net. *D* is now in arrears on his obligations and files a petition invoking the statutory provisions of Chapter XIII and alleges his inability to meet present outstanding obligations. *D* determines that he can cut his necessary living expenses to \$280 per month and his plan proposes to pay \$70 per month on his \$130 per month obligations. The plan is to terminate in 29 months, when *D*'s total debt burden of \$2,000 is completely satisfied. If the court requires full contract payment in the plan as a prerequisite to confirmation, or full payment outside the plan prior to enjoining reclamation, *D* will lose the vehicle unless *C* assents to reduced payments. Since the car is necessary for *D*'s transportation to and from work, the entire plan will fail for he will be unable to earn the funds necessary to implement it.

The other problem presented by the example concerns arrears. The "no modification" line of cases would require arrears to be paid within a specific, reasonable time. However, this requirement will generally compel the payment of both the arrears and the entire balance due, since most contracts call for an acceleration of the amount due upon default.⁴⁶

When the "no modification" position is viewed in the light of the practical problems inherent in its operation, it realistically offers little more than *O'Dell*. Under both lines of reasoning the debtor must maintain his contract payments to secured creditors or permit reclamation of the collateral.⁴⁷

Both the *O'Dell* and the "no modification" positions preclude debtors from extending the period of payment to secured creditors. However, as Congress noted, the key to the Wage Earner Plan is the power of the courts to "change the amount and maturity of installment payments without affecting the aggregate amount [owed]"⁴⁸ It therefore appears that Congress contemplated permitting debtors to extend the payment clauses in their contracts with *all* creditors, so long as, in the case of secured creditors, the amount owed to the value of the security is guaranteed, and the collateral is not impaired.

46. In reference to the problem, one bankruptcy referee has stated that "[a]ny notion about making up arrearages accruing prior to the commencement of the Chapter XIII proceeding . . . should be dismissed as being purely utopian." Poulos, *The Secured Creditor in Wage Earner Proceedings: Dream Versus Reality*, 44 REF. J. 68 (1970).

47. It has been suggested that the effect of the no modification approach is merely to postpone the secured creditor's ability to destroy the plan. Comment, *Bankruptcy: Enforcing a Chapter XIII Wage Earner's Plan Over the Objection of a Secured Creditor*, 6 SAN DIEGO L. REV. 69, 75 (1969).

48. H.R. REP. NO. 193, 86th Cong., 1st Sess. 2 (1959).

To date, however, the "no modification" position has not been tested in connection with the new Chapter XIII Rules of Procedure which were adopted in 1973.⁴⁹ The Rules now provide for an automatic stay of lien enforcement, which may be lifted for cause in the discretion of the court.⁵⁰ Although the courts could still demand full contract payments outside the plan as a condition of continuing the stay, it would be entirely consistent with the automatic stay rule to shift judicial attention away from contract modification and to focus primarily upon the equities.⁵¹ In other words, the fact that the debtor proposed to pay the secured creditor outside the plan at less than the contract rate would not necessarily force the lifting of the stay.⁵²

If this approach were followed in the hypothetical, the court's discretion concerning the stay would be conditioned on all factors, rather than solely upon compliance with the payment provisions in the contract. The court would first note that the car was necessary for the successful operation of the plan. Then, by requiring adequate insurance, the court would negate impairment of the creditor's interest. By also finding that the creditor's interest would not be materially or adversely affected by the delay in payment, the court's discretion in refusing to lift the stay would be properly exercised. In light of the new Rules, it seems reasonable to expect that the "no modification" position will be reevaluated and that the courts which formulated it will adopt a position more in line with the social, economic and humanitarian relief envisioned by Congress in the enactment of Chapter XIII.

The final approach which the courts have taken is to allow the debtor to modify the payment provisions of the secured creditor's contract when necessary to preserve the plan. This position is apparently founded upon the premise that it is far more equitable to subject a creditor to a slight delay in payment rather than destroy a plan and possibly a debtor.⁵³ These courts have achieved their goal procedurally by construing the phrase "dealt with" as being synonymous with the term "affected."⁵⁴ This construction allows the court to make use of section 607 of the

49. See note 9 *supra*.

50. Rule 13-401. Prior to the adoption of the Rules, such stays were within the power of the court, but were not automatic. See note 22 *supra*.

51. This focus on equities is the essential factor in the reasoning of those courts which do permit slight modification of secured creditor payment rights under the contract. See notes 53-57 and accompanying text *infra*.

52. See notes 53-57 and accompanying text *infra*.

53. See, e.g., *In re Thompson*, 475 F.2d 1217 (5th Cir. 1973).

54. See, e.g., *In re Wilder*, 225 F. Supp. 67 (M.D. Ga. 1963). See also Countryman, *Chapter XIII Wage Earners' Plans: Past, Present and Future*, 18 CATH. U.L. REV. 275 (1969).

Bankruptcy Act which states that “[a] creditor shall be deemed to be affected by a plan only if his interest shall be materially and adversely affected thereby.”⁵⁵ By its terms, this language would permit a debtor to submit a plan providing for modification of a secured creditor’s payment rights under his contract and have the plan confirmed over objection, so long as the creditor’s interest was not “materially and adversely affected.” So far only one court has expressly held that the plan itself can provide for contractual modification and still be confirmed over objections.⁵⁶ Other courts have allowed contractual modification, but the result has been achieved through the use of the court’s injunctive power.

In the case of *In re Pizzolato*,⁵⁷ a conditional automobile sales contract provided for sixteen monthly payments of \$70 with a seventeenth and final balloon payment of \$435. The wage earner plan proposed a continuance of the \$70 monthly installments until the full amount of the note had been paid off, but made no provision for the final balloon payment. The secured creditor rejected the plan and appealed a subsequent order enjoining reclamation of the vehicle.⁵⁸

The district court in *Pizzolato*, in sustaining the plan and denying the appeal of the secured creditor, made an extremely important ruling. It held that “dealing with” a secured creditor and the exercise of the court’s injunctive power to prevent the creditor’s foreclosure on the security, though related propositions, were not inseparable. It acknowledged that a secured creditor was “dealt with” if given less than full contractual payments under the plan, but nevertheless ruled that the injunction preventing reclamation was proper and should be upheld. The court decreed that an injunction should issue against a secured creditor “when in the sound discretion of the court, such an injunction is necessary, to meet the ends of equity and justice.”⁵⁹ The factors considered relevant in upholding the exercise of sound discretion were the debtor’s substantial equity in the collateral, the “essential” relation of the collateral to the success and preservation of the rehabilitative plan, the “highly unlikely” probability that the security would be impaired,⁶⁰ and the fact that payments to the

55. Bankruptcy Act § 607 (1973) states in its entirety: A creditor shall be deemed to be ‘affected’ by a plan only if his interest shall be materially and adversely affected thereby. In the event of controversy, the court shall, after hearing upon notice, summarily determine whether any creditor is so affected.

56. *In re Teegarden*, 330 F. Supp. 1113 (E.D. Kan. 1971).

57. 268 F. Supp. 353 (W.D. Ark. 1967).

58. *Id.* at 354.

59. *Id.* at 356.

60. *Id.* at 357. Impairment of the security was considered “highly

secured creditor would not be "seriously" delayed.⁶¹

In allowing and enforcing the contractual modification over the secured creditor's objection, the court was apparently influenced by the equitable realization that reclamation would have the effect of destroying the plan and forcing the debtor into straight bankruptcy. The detrimental consequences of such an event would not be suffered by the debtor alone but would affect other secured and unsecured creditors as well, causing them to recover significantly less on their claims. Given these considerations, it was decided that although the dissenting secured creditor's contract was technically "dealt with," his claim was not "materially and adversely affected" by the plan and it could be confirmed without his acceptance.⁶²

The rationale of this line of cases is that a secured creditor is not "dealt with" by a plan unless it either limits the total amount he may recover or impairs his security interest. These cases stress that equitable considerations may dictate that a creditor technically but not substantively "dealt with" may be enjoined from enforcing his security interest if reclamation would destroy the plan.

The same result will occur under the new Rules when the court refuses to lift the automatic stay. Rather than treating any restriction upon contract rights as impairing the security interest, contractual modifications will be granted providing they neither seriously impair the creditor's right to realize the value of his collateral nor his right to reclaim in the event of default of scheduled payments under the plan. By following this reasoning, the wage earner plan becomes available to many debtors who otherwise would be precluded from enjoying its benefits. By focusing upon the goal to be achieved rather than the statutory language, these courts have succeeded in implementing the congressional intent by providing a viable alternative to straight bankruptcy.

THE PARTIALLY SECURED CREDITOR IN CHAPTER XIII

Another important aspect of Chapter XIII proceedings is the extent to which any creditor shall be deemed secured. The Chapter XIII Rules provide that the bankruptcy judge must value the collateral held by a creditor in order to determine the extent

unlikely" because the vehicle's value was much higher than the amount owed on the note.

61. *Id.* The extension of seven or eight months occasioned by the failure to make the "balloon payment" on the specified contract date was not felt to be a serious delay in payment.

62. *Id.*

to which he shall be deemed secured.⁶³ This rule is merely an application of the general bankruptcy requirement that in order to achieve a fair and equitable distribution of the bankrupt's assets a secured creditor may participate in the general distribution of assets only for the deficiency remaining after deducting the value of the security.⁶⁴

Any creditor whose claim exceeds the value of his security interest is said to be partially secured. The partially secured creditor is deemed to have two claims, one secured and the other unsecured.⁶⁵ A number of interesting results flow from this determination. First, the debtor's plan must provide for the payment of the unsecured portion together with all other unsecured claims as a prerequisite to confirmation,⁶⁶ but the secured claim

63. Rule 13-307(d):

If a secured creditor files a claim, the value of the security interest held by him as collateral for his claim shall be determined by the court. The claim shall be allowed as a secured claim to the extent of the value so determined and as an unsecured claim to the extent it is enforceable for any excess of the claim over such value. For the purposes of this subdivision the court may appoint an appraiser in the manner specified by and subject to the limitations of Bankruptcy Rule 606.

As stated in note 9 *supra*, no Rule may "abridge, enlarge, or modify any substantive right" set forth in the Bankruptcy Act. A recent decision has held that Rule 13-307(d) is invalid. *In re Herman Morales*, 1 Bankr. Ct. Dec. 1210 (N.D. Cal. 1975). This case reasoned that Rule 13-307(d) constituted a modification of a substantive right guaranteed in the Act, rendering the Rule void.

64. Bankruptcy Act § 57h. This principle, termed the bankruptcy rule of distribution, differs from the so-called equity rule which would allow a creditor to participate with his entire claim, keeping his security in reserve to cover any deficiency. See 3 COLLIER, BANKRUPTCY, ¶ 57.20 (14th ed. 1974).

65. Rule 13-202(c) provides:

A creditor whose claim has been allowed in part as a secured claim and in part as an unsecured claim shall be entitled to accept or reject a plan in both capacities unless his secured claim is not dealt with by the plan, in which event he shall be entitled to accept or reject only as an unsecured creditor.

The Bankruptcy Rules Advisory Committee's Note to Rule 13-202(c) states:

Rule 13-307(d) provides that a claim which is only partially secured is to be allowed in part as secured claim and in part as an unsecured claim. If the plan deals with his secured claim, subdivision (c) allows the holder of such a claim to vote in both capacities. If the plan does not deal with his secured claim he is, of course, entitled to vote only as an unsecured creditor. In either event, only the amount of his unsecured claim should be counted in determining whether the plan has been accepted by a majority in amount of unsecured claims within the meaning of § 652(1) of the Act.

66. Prior to the adoption of the Chapter XIII Rules, a bankruptcy referee stated:

Section 646(1) of the Bankruptcy Act requires that all unsecured creditors must be dealt with generally. Any favored treatment jeopardizes the plan since section 656(a)(1) requires that there must be compliance with the provisions of this chapter as a condition to confirmation. Payment of a partially secured claim in accordance with the terms of the contract clearly constitutes favored treatment vis-a-vis other unsecured creditors. Most importantly, section 656(a)(2) requires that the provisions of the plan must be

may or may not be dealt with in the plan at the debtor's option,⁶⁷ and the rights of the creditor as to that claim will be determined in accordance with the previous discussion on secured creditors. Second, since the unsecured claim will be provided for, the creditor will have a vote in the acceptance or rejection of the plan in the capacity of a general, unsecured creditor.⁶⁸ Similarly, if the plan provides for the secured claim, the creditor will have a vote in that capacity as well.⁶⁹ In either event, only the amount of the unsecured claim will be counted in determining whether the plan has been accepted by a majority in amount of unsecured claims for purposes of confirmation.⁷⁰ Third, since a plan may provide for priority of payment as between the secured and unsecured debts affected by the plan,⁷¹ the partially secured creditor will be limited to the value of his security interest in the amount of priority payments he may receive.⁷²

The above provisions of Chapter XIII represent a basic premise of American bankruptcy law in that a fair and equitable distribution will be effected by treating all creditors within the same class on a parity.⁷³ The creditor gets exactly what he bargained for when he entered into the security agreement with the debtor. He stands in the favored role of the secured creditor to the extent that he protected himself, and therefore is guaran-

in the best "interests" of the creditors On either ground, therefore, a plan providing for contract payments to partially secured creditors properly should not be confirmed. Poulos, *The Secured Creditor in Wage Earner Proceedings: Dream Versus Reality*, 44 REF. J. 68, 76 (1970).

67. See note 41 and accompanying text *supra*.

68. See note 65 *supra*.

69. *Id.*

70. *Id.*

71. Bankruptcy Act § 646(3) (1973) states:

A plan under this chapter— . . . (3) may provide for priority of payment during the period of extension as between the secured and unsecured debts affected by the plan.

72. Some interesting problems may arise in this area if the debtor is unable to complete his plan and converts to bankruptcy under Rule 13-215. For example, assume that a partially secured creditor has a claim of \$1,000, which is secured to the extent of \$500, and demands priority as to that portion. Debtor pays \$500 to the creditor and then converts to bankruptcy. What is the creditor's status in the bankruptcy proceedings: secured, partially secured, or unsecured? Since he took priority payments on his security, he will probably be deemed to have received payment to the value of his security, and therefore will have a \$500 unsecured claim in the bankruptcy proceeding. However, if the creditor had not demanded priority and had merely been paid pro rata with all other creditors in the Chapter XIII proceeding, he will be deemed to still be secured and the lien will have been preserved. Upon conversion to bankruptcy, if the debtor had few assets (as is usually the case), the creditor who demanded priority will have received \$500 and will take a pro rata share of the remaining assets, whereas the debtor who did not take priority payments will have received \$500 and will be entitled to his security worth \$500, thus receiving full payments of his claim.

73. *United States National Bank v. Chase National Bank*, 331 U.S. 28, 34 (1947).

teed either full payment to the value of the collateral, or the exercise of his security rights under the Uniform Commercial Code.

The provisions requiring valuation of security came into effect in 1973 as part of the Chapter XIII Rules. The need to codify this area of procedure was deemed imperative, since no reported Chapter XIII case had ever differentiated between secured and partially secured creditors.⁷⁴ Indeed, in the only case ever addressing the problem, the court ruled that partially secured creditors were to be treated as those fully secured.⁷⁵ The vast majority of courts apparently failed to recognize that a problem existed.⁷⁶ Regardless of the value of any security held by a creditor, he was referred to as a "secured creditor" and was permitted to enjoy all the benefits flowing from that designation.⁷⁷ When this is coupled with the fact that the majority of courts accord full contract payments to "secured creditors," the inequitable results of many cases are understandable.

Courts following the *O'Dell* line of reasoning placed the partially secured creditor in a strong bargaining position since he was permitted to prevent adoption of a proposed plan by his single dissent. By threatening to exercise his veto power, the partially secured creditor could demand that the plan provide for his payment in full according to the terms of his contract as a condition to his acceptance of the plan. However, if the partially secured creditor were to be paid in full, according to the terms of his contract, there may be insufficient funds available to pay general creditors. In such cases, the unsecured creditors would probably reject the plan because after the debtor had made payments to his secured and partially secured creditors in full, the money available for proportional distribution among unsecured creditors would be too little to justify bookkeeping and collection costs. If the "no modification" line of reasoning were followed, and the terms of the partially secured creditor were not met, he would be permitted to reclaim possibly vital collateral which could frustrate the plan.

Such results were manifestly inequitable when the value of the partially secured creditor's security interest was disproportionately small in relation to the debt owed him. The partially

74. See generally Comment, *The Partially Secured Creditor Under Chapter XIII of the Bankruptcy Act*, 3 PROSPECTUS 285 (1970); Comment, *Debtors Dilemma: Status of the Secured Creditor Under Chapter XIII of the Bankruptcy Act*, 4 U.C.D.L. REV. 277 (1971).

75. *In re Worley*, CCH Bankr. L. Rep. ¶ 64, 283 (E.D. Mich.), *aff'd. sub nom. Worley v. Budget Credit, Inc.*, CCH Bankr. L. Rep. ¶ 64, 285 (6th Cir. 1971), *cert. denied*, 406 U.S. 407 (1972).

76. See note 34 and accompanying text *supra*.

77. *Id.*

secured creditor was given significantly greater control over the debtor's property than was warranted by his security interest. Moreover, the objectives of fairness and equity which underlie the entire Bankruptcy Act were being thwarted, and the specific objective of Chapter XIII of providing a means of relief and rehabilitation to the wage earner debtor was being defeated.

PROPOSED BANKRUPTCY ACTS

Two proposed comprehensive Bankruptcy Acts are now before Congress.⁷⁸ From the standpoint of the Chapter XIII debtor and his secured creditors, however, no sweeping changes are contemplated. Rather, the proposed Acts attempt to codify the present case law which is most conducive to debtor rehabilitation, while retaining many of the current statutory provisions and Rules of Chapter XIII which promote that end.

Under the proposed Bankruptcy Acts, the debtor will offer a plan calling for a composition or extension of indebtedness, or for a composition of some and an extension of other indebtedness.⁷⁹ The debtor will be required to submit a plan which includes provisions dealing with unsecured claims generally. The plan, however, may alter or modify the rights of the holders of such claims in the same manner as is presently allowed.⁸⁰

The debtor may also include in his plan provisions dealing with claims secured by personal property severally.⁸¹ This section retains the permissive language contained in Chapter XIII and allows the debtor to provide for all, some or none of his secured creditors within his plan. The proposed Acts would also permit the debtor's plan to provide for the curing of defaults within a reasonable time and *otherwise modify the rights of the holders of such claims*.⁸² Furthermore, the court is required to confirm the debtor's plan if it "provides for the preservation to each secured creditor affected by the plan of the value of his claim against the property of the debtor. . . ."⁸³ Under these sections, the contract rights of any secured party may be modified so long as the creditor's interest in the security is not impaired. In other words, a creditor will not be deemed "affected" by a plan

78. The two bills are the Bankruptcy Commission Bill (H.R. 10792 and S. 2565, 93rd Cong., 1st Sess. (1973), reintroduced as H.R. 31 and S. 236, 94th Cong., 1st Sess. (1975)) and the National Conference of Bankruptcy Judges Bill (H.R. 16643 and S. 4046, 93rd Cong., 2nd Sess. (1974), reintroduced as H.R. 32 and S. 235, 94th Cong., 1st Sess. (1975)).

79. Bankruptcy Commission Bill Sec. 6-201; National Conference of Bankruptcy Judges Bill Chapter VI, Part 3.

80. See note 79 *supra*.

81. *Id.*

82. *Id.* (emphasis added).

83. Bankruptcy Commission Bill Sec. 6-204(b); National Conference of Bankruptcy Judges Bill Chapter VI, Part 3.

unless he is somehow precluded from realizing at least the value of his general interest in the debtor's property.

The adoption of either of the new Acts would satisfactorily solve the secured creditor problem and should make the use of wage earner plans much more attractive and workable by allowing debtors to extend the rate of payment to all creditors. Under both Acts creditors are guaranteed exactly what they bargained for, losing only the power to arbitrarily veto plans which many courts have held exists under the present law. In short, the two proposed Bankruptcy Acts offer a substantial restatement and clarification of the fundamental principles which underlie Chapter XIII.

CONCLUSION

The conflicting opinions concerning the rights of secured creditors are indicative of the uncertainty which presently reigns in the courts regarding the judicial function in Chapter XIII proceedings. Are the courts to give priority to secured creditors or to the wage earner's plan? The solution to this problem may be found in three interconnected principles at work in all Chapter XIII cases involving non-assenting secured creditors. First, the courts must recognize that impairment of contract rights is the essence of our bankruptcy system,⁸⁴ and that the extension of payment concept incorporates this principle into Chapter XIII proceedings. Second, the mandate of the due process clause of the Constitution compels preservation of the secured creditors' interest or property rights. Thus, the courts must guarantee such creditors payment to the value of their security, and at a rate sufficient to cover the depreciation on the collateral.⁸⁵ Third, since Congress clearly intended that wage earner plans should succeed whenever feasible, the courts have an obligation to implement this purpose.

In construing these principles together, it becomes readily apparent that the courts should implement all wage earner plans which properly preserve a dissenting secured creditor's interest in his collateral. Creditors should not be deemed "dealt with" by a plan, nor should the automatic stay be lifted, unless the court determines that the secured creditor's interest is impaired.

Many courts, however, have failed to apply these fundamental principles. They appear preoccupied with interpreting the statutory language of Chapter XIII without capturing or heeding the spirit underlying the Chapter's creation. By focus-

84. *Hanover National Bank v. Moyses*, 186 U.S. 181 (1902).

85. *Wright v. Vinton Branch*, 300 U.S. 440 (1937); cf. *Seidman, The Plight of the Secured Creditors in Chapter XI*, 80 *Com. L.J.* 343 (1975).

ing upon phrases such as "dealt with" and "affected by" rather than viewing the problem in terms of protected property rights and modifiable contract rights, these courts often thwarted the congressional purpose in passing Chapter XIII and denied its envisioned relief.

The judiciary, however, is not entirely to blame. When courts must work within the confines of poorly drafted statutory material, conflicts are inevitable. The judicial variance in the interpretation and application of the statutory scheme dealing with the secured creditor indicates the appropriateness of a legislative solution. Of all the Chapter XIII provisions, none is in more urgent need of reform and clarification than those delineating and defining the role of the secured creditor.

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