UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF WASHINGTON

In Re: FREY, KRISTEN E., Debtors.	No. 00-05174-W13
In Re: MASON, BRIAN F., Debtors.	No. 00-04033-W13 MEMORANDUM DECISION

THIS MATTER came on for hearing before the Honorable Patricia C. Williams on February 6, 2001 for confirmation of the Chapter 13 Plan. Debtors were represented by Timothy Durkop and the Chapter 13 Trustee was represented by Joseph Harkrader. The court reviewed the files and records herein, heard argument of counsel and was fully advised in the premises. The court now enters its Memorandum Decision.

CLASSIFICATION OF CLAIMS UNDER 11 U.S.C. § 1322

At its most simplistic, the issue concerns the proper classification and payment of student loan obligations in a Chapter 13 proceeding. An analysis of classification of claims in Chapter 13 proceedings begins with 11 U.S.C. § 1322(a) which provides that each claim of a particular type or class is to be treated the same as other claims of the same type or class. Similar treatment of similar claims is one of the core principles

3/7/01 Ecf

37

of bankruptcy reorganization. It is, however, a principle and not an unvarying rule. 11 U.S.C. § 1322(b)(1) provides that subject to the principle established in 11 U.S.C. § 1322(a), a separate class of unsecured claims may be established if that separate classification does not "discriminate unfairly." The subsection allows an exception to the similar treatment required for similar claims by 11 U.S.C. § 1322(a) if that dissimilar treatment is "fair." If it is unfair, it is prohibited by § 1322(b)(1).

The only purpose served by separate designation of a class of unsecured claims in a Chapter 13 is to treat those claims differently than other unsecured claims. This different treatment generally takes the form of a difference in the percentage of payment and the time when such payments are disbursed. The term "discriminate unfairly" in § 1322(b)(1) implies that a Chapter 13 debtor may discriminate to some degree in a plan.

Subsection § 1322(b)(5) concerns either secured or unsecured claims "on which the last payment is due after the date on which final payment under the plan is due." Such claims are commonly referred to as "continuing claims" as the obligation continues past the duration of the Chapter 13 plan. 11 U.S.C. § 1322(b)(5) expressly allows debtors to pay continuing claims according to their terms and to cure the arrearage. Undoubtedly, there are many unsecured claims which have repayment terms longer than a proposed plan such as credit cards with their minimum monthly payments and unsecured promissory notes. However, those unsecured claims will be discharged upon completion of the plan and do not therefore extend beyond the term of the plan. Absent unusual circumstances, separate classification of unsecured claims under § 1322(b)(5) is

meaningless except in the context of non-dischargeable debt.

ISSUE

The debtors argue that 11 U.S.C. § 1322(b)(1) does not apply to continuing claims as § 1322(b)(5) allows regular payments to be made and the arrearage cured during the term of the plan. As the Code allows such treatment of continuing claims, the debtors argue this treatment is therefore fair discrimination. The Chapter 13 Trustee argues that although § 1322(b)(5) allows such treatment, such treatment must still meet the requirements of § 1322(b)(1), i.e., must be fair in the context of the specific Chapter 13 proceeding.

ARE CONTINUING CLAIMS UNDER 11 U.S.C. § 1322(b)(5) SUBJECT TO THE UNFAIR DISCRIMINATION TEST OF 11 U.S.C. § 1322(b)(1)?

Student loan obligations are not dischargeable. If other unsecured creditors were before the court arguing this matter, those unsecured creditors would undoubtedly argue that it is patently unfair for those holding non-dischargeable claims (who have the right to engage in post-bankruptcy discharge collection efforts) to be preferred not only after discharge but also during the term of the plan.

11 U.S.C. § 1322 must be read as a whole. Firstly, it restates a core bankruptcy principle that similar claims should be treated similarly. Secondly, § 1322(b)(1) provides an exception to that principle by allowing dissimilar treatment of similar secured and unsecured claims if the dissimilar treatment is fair. That provision applies to all unsecured claims. Subsection (b)(5) then provides for dissimilar treatment of both secured and unsecured claims if such claims extend beyond the term of the plan. Allowing

preferential treatment under § 1322(b)(5) of student loan obligations which happen to extend beyond the term of the plan would render § 1322(b)(1) superfluous. Permitting any classification under § 1322(b)(5) as exempt from the prohibition of unfair discrimination in § 1322(b)(1) is logically inconsistent when reading § 1322 as a whole, contrary to the principle of similar treatment found in § 1322(a), and does not appear to be consistent with Congressional intent. Effect can be given to § 1322(b)(5) by allowing Chapter 13 debtors to separately classify continuing claims subject to the unfair discrimination limitation found in § 1322(b)(1). *In re Coonce*, 213 B.R. 344 (Bankr. S.D. Ill. 1997); *In re Williams*, 253 B.R. 220 (Bankr. W.D. Tenn. 2000); and *In re Thibodeau*, 248 B.R. 699 (Bankr. D. Mass. 2000).

Nor is there any language in the form Chapter 13 plan utilized in this District which is contrary to such a reading of § 1322. Paragraph III A.(7) adopted by Local Bankruptcy Rule 2083-1 in this District, refers to unsecured creditors "separately classified pursuant to 11 U.S.C. § 1322(b)(1) . . . ." That provision of the form plan allows debtors to select various options when separately classifying unsecured claims. It neither prevents nor mandates separate classification under § 1322(b)(5) either in that subparagraph or in paragraph III A.(2) entitled "Continuing Claims." The language of the form plan is silent as to the applicability of § 1322(b)(1) to the separate classification of unsecured claims which extend beyond the life of the plan.

The court in *McDonald v. Sperna (In re Sperna)*, 173 B.R. 654 (B.A.P. 9th Cir. 1994) held that the non-dischargeable nature of a student loan is not of itself a reasonable basis of discrimination.

The *Sperna* court rejected the argument that the debtor's right to a "fresh start" required emergence from bankruptcy completely free of all debt. It also rejected the notion that special provisions for collection of non-dischargeable debts, although relevant, would justify effecting a subordination of all other unsecured claims. There must be additional reasons for the dissimilar treatment. As stated above, separate classification of unsecured debt under § 1322(b)(5) is meaningless except in the context of non-dischargeable debt. Since the fact an obligation is not dischargeable is alone insufficient justification for separate classification, the nature and repayment terms of the non-dischargeable unsecured debt and the specific terms of the debtor's plan must be examined to determine whether separate classification of the unsecured continuing claim under § 1322(b)(5) is fair. Unsecured continuing claims may be separately classified unless the separate classification results in unfair discrimination which is determined with reference to the facts of the specific case.

FACTS OF *MASON*, NO. 00-04033-W13

Mason, the debtor, is employed and has a net monthly income of $1,479. His plan proposes to pay $248 month for 36 months with a base of $8,928. According to the plan, he owes a student loan obligation to United Student Aid Funds, Inc. (hereinafter "USA Funds") which has a regular monthly payment of $95 which is in default and which will continue past the term of the plan. The Proof of Claim by USA Funds is $7,152.40, but it does not state the regular monthly payment or amount of any arrearage or amount past due. According to the plan, the debtor owes a student loan obligation to Chemical Bank which has a regular monthly payment of

$25 which is in default and which will continue past the term of the plan. No Proof of Claim has been filed by Chemical Bank. The plan provides that the $750 arrearage to USA Funds is to be paid at 8% interest which results in a monthly distribution of $30. The $967 arrearage to Chemical Bank is to be paid at 8% interest resulting in a monthly distribution of $40. Thus, out of the base of $8,928, the Trustee will distribute $4,320 to maintain regular monthly payments on the student loans, $1,881 to cure the arrearage on the student loans, and $1,049 to other unsecured creditors. Those other unsecured creditors hold claims of $8,738.23.

FACTS OF *FREY*, NO. 00-05174-W13

Ms. Frey is employed and has net monthly income of $1,230, including food stamps. Her plan proposes to pay $176 monthly for 40 months with a base of $7,067.00. According to her plan, she has one student loan with the U.S. Department of Education which has a regular payment of $69.00 and which continues past the term of the plan. The plan does not provide for the payment of any arrearage and there is no indication one exists. No Proof of Claim has been filed by the U.S. Department of Education. Thus, out of the base of $7,067.00, the Trustee will disburse $2,760 to maintain the regular payments on the student loan, pay the secured claim with interest and disburse about $341 to other unsecured claims. Those other unsecured claims total $8,946.11.

IS THE DISCRIMINATION FAIR?

The court suggested to counsel that the submission of any additional factual evidence await the court's determination of the underlying legal issue of whether the unfair discrimination test of § 1322(b)(1) is applicable to separately classified continuing

claims under § 1322(b)(5). The court has assumed for purposes of this opinion that the regular monthly payments required on the student loan obligations at the commencement of the bankruptcy proceedings were the amounts referenced in the plans and that the obligations in *Mason* were in default and the obligation in *Frey* was not in default. The court has assumed that the contractual terms of the student loans in effect at the time of the bankruptcy filing required payments which would extend beyond the life of the proposed plans. The mathematical calculations performed by the Trustee indicate that a pro rata distribution to a class composed of all unsecured creditors, including these student loans, would be insufficient to maintain the contract payments on the student loans.

In determining whether a proposed separate classification unfairly discriminates, the Ninth Circuit as well as other circuits, has developed a four part query: (1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination. *In re Wolff*, 22 B.R. 510 (B.A.P. 9th Cir. 1982), *Mickelson v. Leser (In re Leser)*, 939 F.2d 669 (8th Cir. Minn. 1991). This four part query has been applied in considering separate classification of student loans. *In re Sperna, supra*. This four part query has been applied in this District pursuant to *In re Games*, 213 B.R. 773 (Bankr. E.D. Wash. 1997) and *In re Ponce*, 218 B.R. 571 (Bankr. E.D. Wash. 1998).

The student loans in these cases are continuing obligations

or, to utilize the language of § 1322(b)(5), "an unsecured claim . . . on which the last payment is due after the date on which the final payment under the plan is due." Unlike many unsecured non-dischargeable debts such as criminal fines which are due in full when imposed or immediately thereafter, student loan obligations arise from a voluntary contract between the debtors and lenders which contracts require periodic payments extending for many years. In situations involving criminal fines, the obligation is fully due and payable prior to the bankruptcy proceeding. Debtors are invariably "in default" when the Chapter 13 is commenced. In situations involving long-term contract payments, the obligation may fully mature long after completion of the Chapter 13 plan. Debtors may not be in default when the Chapter 13 is commenced. Forcing debtors under those circumstances to place the student loan obligations in a class with all other unsecured creditors would certainly be unfair to both the debtor and the student loan creditor. It would create a default in a non-dischargeable debt when none existed at the time of filing. The maintenance of the contractually required periodic payments when such obligations are not in default, is a reasonable basis for the discrimination. In that situation, prohibiting a debtor from maintaining payments on the obligation during the term of the plan would impinge on the "fresh start" provisions of 11 U.S.C. § 524. After discharge, the debtor would be faced with greater non-dischargeable debt than if the debtor had not sought Chapter 13 relief.

Ms. Frey could have commenced a Chapter 7 proceeding and discharged all other unsecured obligations, received her fresh

start and simply continued making the regular contract payments on the student loan. Instead, she has proposed a plan which would make some distribution to other unsecured creditors, albeit minimal. Those other unsecured creditors are receiving the benefit of the Chapter 13 process, i.e., pro rata distribution from the debtor's disposable income. The debtor is receiving her fresh start. Although the debtor will still be liable for these non-dischargeable student loans after completion of the Chapter 13 plan, the amount of the non-dischargeable obligation will not have increased due to the debtor's election to file a Chapter 13 rather than a Chapter 7.

Application of the Ninth Circuit's four part inquiry to Ms. Frey's proposed plan, based on the assumptions made above, leads to the conclusion that the proposed separate classification and the resulting discrimination in treatment is fair as it relates to the maintenance of regular contract payments when no pre-petition default exists. Such a provision has a reasonable basis and is fair.

Mr. Mason's obligations were in default at the commencement of the bankruptcy. If Mr. Mason had sought Chapter 7 relief, he would have paid nothing to general unsecured creditors. Immediately after discharge, the regular contract payments on the student loans and, if necessary, arrearage payments, could have been made. Within 36 months, Mr. Mason would have reduced non-dischargeable obligations. However, Mr. Mason chose to commence a Chapter 13 proceeding and pay general unsecured creditors for 36 months to the extent of his ability to do so. Unsecured creditors will receive a distribution in the Chapter 13 proceeding. If Mr. Mason were not

allowed to make regular contract payments on the student loans during the Chapter 13 plan, at the end of the 36-month plan, he would owe more in non-dischargeable debt than if he had sought Chapter 7 relief. Both the debtors in the *Mason* and *Frey* proceedings, if not allowed to make regular contract payments on the student loans during the Chapter 13 plans, would at the end of plan terms owe more in student loans than if they had elected Chapter 7 relief. Prohibiting debtors in such situations from maintaining regular payments on student loan obligations during the Chapter 13 plan would discourage such debtors from electing Chapter 13 proceedings. Since general unsecured creditors are often benefitted from a debtor's election of Chapter 13, it is fair and reasonable to encourage the use of Chapter 13 proceedings by allowing debtors to maintain regular contract payments on the continuing student loan claims during the Chapter 13 plan.

However, it is not fair and reasonable to allow Mr. Mason to cure the arrearage on the student loans during the term of the plan. Even though § 1322(b)(5) implies that some preferential treatment of the continuing claims may be considered fair, Mr. Mason's proposed plan goes beyond fair preferential treatment. It places the debtor in a more favorable post-bankruptcy position by reducing the non-dischargeable debt, but does so at the expense of the general unsecured creditors. There is a great discrepancy between the return to unsecured creditors and the return to the student loan creditor under the proposed Mason plan. Allowing a cure of the arrearage only increases that discrepancy. Debtors should not be penalized for electing Chapter 13 relief by an increase in the non-dischargeable debt nor should debtors be

rewarded for defaulting pre-petition in their student loan obligations by allowing debtors to cure that default at the expense of general unsecured creditors. General unsecured creditors may only recover their pro rata share of disposable income during the term of the plan. The non-dischargeable student loan creditor may, post-discharge, pursue remedies for any defaults that then exist. In the *Mason* proceeding, allowing those defaults to be cured during the term of the plan unfairly increases the degree of discrimination between the general unsecured creditors and the student loan creditors.

CONCLUSION

The plan proposed in *Frey*, No. 00-05174-W13, would be confirmable even with its separate classification under § 1322(b)(5) once evidence consistent with the court's assumptions is provided. The plan in *Mason*, No. 00-04033-W13, proposes to cure the arrearage on the student loans as well as maintain the regular contract payments. Even after receiving evidence consistent with the court's assumptions, this plan cannot be confirmed. On its face it is unfair under the analysis of the applicable factors.

Debtors' counsel shall have thirty (30) days to file the appropriate affidavits or declarations regarding the terms of the student loan contracts at the time of the commencement of the bankruptcy proceeding, i.e., the amount of the regular monthly payment, the length of the repayment period and whether default existed or whether the obligation had fully matured. Once such evidence is provided, counsel should contact the Chapter 13 Trustee to schedule a hearing at which time an order consistent with this decision and the evidence can be entered.

The Clerk of the Court is directed to file this Memorandum Decision and provide copies to counsel.

DATED this 8th day of March, 2001.

PATRICIA C. WILLIAMS, Bankruptcy Judge