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Chapters 11 and 13 of the Bankruptcy Code—Observations on Using Case Authority from One of the Chapters in Proceedings Under the Other

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I. INTRODUCTION

This Article will focus on the relationship between Chapter 11 and Chapter 13 of the Bankruptcy Code. A number of issues are similar or identical in Chapter 11 and Chapter 13. Furthermore, much of the language of Chapter 13 mirrors that of Chapter 11. This Article explores whether courts should apply case law and concepts of one chapter when similar issues arise in proceedings under the other chapter.

Parts II and III of this Article address basic similarities and differences between Chapters 11 and 13. Parts IV, V, and VI examine three issues governed by statutory language common to both chapters. Part IV discusses the discount factor applied in determining present value of deferred cash payments in a Chapter 11 or Chapter 13 plan. Part V analyzes the grounds for relief from an

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1. Title 11 of the United States Code contains the substantive law of bankruptcy. The statute is divided into eight chapters:
   Chapter 1, General Provisions, Definitions and Rules of Construction;
   Chapter 3, Case Administration;
   Chapter 5, Creditors, the Debtor and the Estate;
   Chapter 7, Liquidation;
   Chapter 9, Adjustments of the Debt of a Municipality;
   Chapter 11, Reorganization;
   Chapter 13, Adjustment of the Debts of an Individual with Regular Income; and
   Chapter 15, United State Trustees.

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automatic stay. Part VI addresses the classification, under either chapter, of “substantially similar” claims.

II. SIMILARITIES BETWEEN CHAPTERS 11 AND 13

There are some obvious similarities between Chapters 11 and 13. For example, the provisions of Chapters 1, 3, and 5 generally apply in both Chapter 11 and Chapter 13 cases. Usually, both chapters are described as debtor rehabilitation chapters. In the typical Chapter 11 or 13 case, the debtor retains her assets after filing a bankruptcy petition. Furthermore, both chapters follow the same general procedure. The debtor prepares a plan of rehabilitation or repayment. The court reviews the plan. The plan becomes effective after approval or confirmation by the bankruptcy judge. Finally, pursuant to this court approved plan, the debtor makes payments or other distributions to the creditors, usually from her postpetition earnings.

III. DIFFERENCES BETWEEN CHAPTERS 11 AND 13

Some obvious differences distinguish the commencement of a Chapter 11 and Chapter 13 case. A Chapter 11 case can be voluntary or involuntary. Thus, either a debtor or its creditors can file a Chapter 11 petition. In contrast, every Chapter 13 case is voluntary. Thus, a debtor must choose to file for Chapter 13 relief.

Only certain debtors can choose to file under Chapter 13. The use of Chapter 13 is subject to debt limitations and restricted to individuals. Partnerships and corporations cannot file for relief under Chapter 13. Although an individual who is operating a business as a sole proprietorship or conducting a professional practice can file a Chapter 13 petition, most Chapter 13 debtors are “consumer debtors.” In contrast, Chapter 11 is not limited to individuals, partnerships, or corporations. Any “person” is eligible for relief under Chapter 11. Although a “consumer debtor” can file a Chap-

3. Id. §§ 301, 303.
4. Id. § 303(a) (“An involuntary case may be commenced only under Chapter 7 or 11 of this title . . . .”).
5. Id. § 109(e).
ter 11 petition,9 most Chapter 11 debtors are businesses, farmers, investors, or professionals.

The differences between Chapters 11 and 13 are not limited to the commencement of the case. The chapters typically involve different participants. Every Chapter 13 case has a trustee—usually a standing trustee.9 Generally, there will not be a trustee in a Chapter 11 case.10 Every Chapter 11 case, however, has a creditors’ committee whose statutory duties permit it to “consult with the trustee or debtor in possession concerning the administration of the case,” and “participate in the formulation of the plan.”11

When a trustee is appointed in a Chapter 11 case, her duties are very different from the trustee’s duties in a Chapter 13 case.12 The Chapter 11 trustee takes possession of the property of the estate and operates the business of the debtor. The Chapter 13 trustee does not have this power.13 A Chapter 11 trustee also has the responsibility for the formulation of the reorganization plan.14 In Chapter 13, only the debtor can file a plan.15

The role of creditors in the two chapters also is very different. As noted above, there is a creditors committee in Chapter 11 that is involved in both the administration of the case and the formulation of the plan. A Chapter 11 plan is submitted to creditors for vote.16 Chapter 11 creditors can accept or reject the debtor’s or trustee’s plan, or submit their own plan. A Chapter 11 plan does not have to receive the affirmative approval of all or even a majority of all creditors. The requisite majority of at least one class of creditors, however, must approve the plan in a Chapter 11 case.17

14. Id. § 1106(a)(5).
15. Id. § 1321.
In contrast, Chapter 13 provides no creditors' committee, no creditors' vote, and no possibility for a creditors' plan.\textsuperscript{18}

While both Chapter 11 and Chapter 13 require that the judge approve the plan, some of the confirmation standards are different.\textsuperscript{19} Furthermore, the effect of confirmation of a Chapter 11 plan is different from the effect of confirmation of a Chapter 13 plan. In Chapter 11, confirmation effects a discharge.\textsuperscript{20} This discharge means that when the court approves the Chapter 11 plan, the debtor's obligations on his prepetition debts are limited to what was called for by the plan. Confirmation in a Chapter 11 case also simultaneously terminates the automatic stay.\textsuperscript{21} Confirmation of a Chapter 13 plan does not automatically terminate the stay. Chapter 13 does not allow a discharge until the debtor completes her payments under the plan or receives a hardship discharge.\textsuperscript{22}

Finally, there are differences between a Chapter 11 and a Chapter 13 discharge. An individual debtor's Chapter 13 discharge is more comprehensive than a Chapter 11 discharge. A Chapter 11 discharge is subject to all the exceptions set out in section 523(a).\textsuperscript{23} On the other hand, if a Chapter 13 debtor completes the payments called for by her plan, the discharge will be subject only to the section 523(a)(5) exception for family obligations.\textsuperscript{24}

\begin{footnotes}
\item[19] Id. §§ 1129, 1325. For example, Chapter 13 requires that the plan either provide for full payment of all unsecured claims or commit all of the debtor's "disposable income" to the plan. Chapter 11 contains no comparable test. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 317, 98 Stat. 333, 356 (to be codified at 11 U.S.C. § 1325(b)); see infra notes 125-29 and accompanying text.
\item[21] Id. § 362(c)(2)(C).
\item[22] Id. § 1328. While confirmation of a Chapter 13 plan does not effect a termination of the automatic stay, it does affect the grounds for relief from the stay. Courts have held that confirmation of a Chapter 13 plan prevents the use of § 362(d)(2) and limits "cause" for purposes of § 362(d)(1) to matters occurring after the confirmation. See, e.g., In re Clark, 38 Bankr. 683 (Bankr. E.D. Pa. 1984); In re Lewis, 8 Bankr. 132 (Bankr. D. Idaho 1981). The reasoning supporting these holdings is that the plain language of § 1327(a) vitiates the applicability of § 362(d)(2). See Clark, 38 Bankr. at 684; Lewis, 8 Bankr. at 136-37. Section 1327 states: "The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan." 11 U.S.C. § 1327(a) (1982).
\end{footnotes}
Though this section of the Article has listed many differences between Chapters 11 and 13—differences that may profoundly affect the rehabilitation process—the case authority from one chapter still offers some precedential value to like issues arising in proceedings under the other chapter. The rest of this Article examines the applicability of this precedent as well as the inherent limits on its applicability.

IV. THE RATE OF INTEREST REQUIRED BY “VALUE, AS OF THE EFFECTIVE DATE OF THE PLAN”

In both Chapter 11 and Chapter 13, the plan can provide for periodic payments. Chapter 13 plans generally provide for payments over a three year period. The court, however, can approve a Chapter 13 plan that has a five year payment period. There is no statutory limitation on the payment period of a Chapter 11 plan: both three and five year plans are common.

Obviously, payment of $X$ dollars over a three to five year period is less valuable to a creditor than an immediate cash payment of $X$ dollars. Accordingly, both section 1129 of Chapter 11 and section 1325 of Chapter 13 test the adequacy of a plan’s deferred cash payments to the holder of a secured claim by looking to the “value, as of the effective date of the plan” of the deferred cash payments. The statutory language is exactly the same in both chapters.

Most of the reported cases interpreting this phrase have arisen under Chapter 13. Should a court look to and rely on these Chapter 13 present value cases in determining whether a Chapter 11 plan meets the present value test of section 1129?

Recently, a bankruptcy court in Utah considered that general question at length in In re Loveridge Machine & Tool Co. In Loveridge, the Chapter 11 debtors owed Northwest, a trade creditor, $448,807. The contract creating the debt provided for nineteen percent interest. Northwest’s claim was secured by equipment, inventory, and accounts. The parties agreed that the collateral’s value was greater than the amount of Northwest’s claim. Debtors and Northwest, however, did not agree on how debtors’ Chapter 11 plan should treat Northwest’s secured claim. The plan classified Northwest’s claim in a separate class and proposed to pay North-

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25. Id. § 1322(c).
28. For a discussion of the relationship between Chapter 11 and Chapter 13 on classification, see infra notes 84-120 and accompanying text.
west the full amount of its secured claim, including legal fees and interest, over a six to seven year period. Northwest disagreed only with the plan’s proposed interest rate on its fully secured claim. The interest rate was to be measured by “the Legal Rate as defined in 28 USC Section 1961.”

To confirm the plan over Northwest’s dissent, bankruptcy Judge Glen Clark had to determine whether paying interest at a rate measured by 28 USC section 1961(a) met the “value, as of the effective date of the plan” test of section 1129(b). 28 USC section 1961(a) governs the interest rate of money judgments in federal civil cases. A number of bankruptcy cases have held that a plan providing for posteffective date interest at a rate tied to 28 USC section 1961(a) satisfies the “value, as of the effective date of the plan” test. Most of these cases are Chapter 13 cases.

The Loveridge court rejected these precedents and denied the debtors’ motion for confirmation. Judge Clark questioned the applicability of the present value analysis in Chapter 13 cases to the consideration of the proper discount rate for deferred payments to an objecting holder of a secured claim under a Chapter 11 plan. The Loveridge opinion set out several differences between Chapter 11 and Chapter 13 to justify reading the phrase “value, as of the effective date of the plan” differently in Chapter 11 cases than in Chapter 13 cases.

A. Statutory Language

The Loveridge court first noted that section 1129(b)(1) has a “fair and equitable” rule while section 1325(a)(5) does not. The court stated that “[t]his unique Chapter 11 requirement may, in some cases, dictate interest rates different from those which would be applied in a pure present value analysis.” The court provided no support for this statement, and the authors are unable to find any. The phrase “fair and equitable” has a long bankruptcy history. The standard was used in Chapter X of the Bankruptcy Act of 1898 and was construed as requiring absolute priority among classes of claims and interests according to their ranks. Courts

29. Interest is based on treasury bill rates. The Director of the Administrative Office of United States Courts distributes notices of the prevailing rates to federal judges.
31. 36 Bankr. at 168.
32. See, e.g., Consolidated Rock Prods. Co. v. Dubois, 312 U.S. 510 (1941); Northern Pac. Ry. v. Boyd, 228 U.S. 482 (1913); see also 5 COLLIER ON BANKRUPTCY ¶ 1129.03[2] (L.
and commentators generally describe the fair and equitable standard as an absolute priority rule. Under this description, Loveridges' Chapter 11 plan was fair and equitable respecting Northwest's secured claim if Northwest was to be paid in full before unsecured creditors and other junior classes of claims and interests received anything.

Although the phrase "fair and equitable" controls the order in which claims are paid, it would not seem to affect the rate of post-effective date interest as the Loveridge Court suggested. Therefore, the "fair and equitable" component in Chapter 11 would not seem to justify interpreting "value, as of the effective date of the plan" differently in Chapter 11 cases than in Chapter 13 cases.

B. Risks of Nonpayment

The Loveridge court's second reason for discounting Chapter 13 case authority on interest rates in applying section 1129(b) is that the "risk of nonpayment in Chapter 13 [is] significantly different from the risk of nonpayment in Chapter 11."\(^{33}\) As Judge Clark points out, in Chapter 13 a standing trustee is statutorily obligated to collect and disburse payments.\(^{34}\) In most Chapter 11 cases, there is no trustee. Furthermore, "Chapter 13 debtors who complete their plans receive a broader discharge than individual debtors in Chapter 11."\(^{35}\) Because of this more comprehensive discharge, Chapter 13 debtors have a greater incentive than Chapter 11 debtors to complete their payments. No meaningful empirical studies compare the risks of nonpayment faced by holders of secured claims in Chapter 11 and Chapter 13 cases. The legal factors considered in Loveridge suggest that Chapter 13 may present lower risks. Other legal factors, however, suggest that Chapter 11 presents lower risks. If a Chapter 11 debtor fails to make payments under a Chapter 11 plan, the affected creditors can bring collection actions in any federal or state court with jurisdiction. Since the confirmation of a Chapter 11 plan effects a discharge, the automatic stay automatically terminates as soon as a Chapter 11 plan is confirmed.\(^{36}\) The debtor's failure to make payments under a Chapter 13 plan has different consequences. Before bringing the collec-

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33. 36 Bankr. at 168.
35. 36 Bankr. at 168; see also supra notes 22-24 and accompanying text.
B. Liquidation Action

In a Chapter 13 case, the affected creditors must file a motion with the bankruptcy court to obtain relief from the automatic stay.37

Dean Nimmer of the University of Houston Law Center suggests another reason that creditors have lower risks in business Chapter 11 cases than in consumer Chapter 13 cases: “In both cases, the sole bankruptcy alternative is a Chapter 7 liquidation. For businesses, however, liquidation terminates the effective existence of the entity and sacrifices perceived opportunities to salvage going concern value from assets. In contrast, an individual remains a functioning economic unit after liquidation.” Thus, the Chapter 11 business debtor may be less likely to convert from rehabilitation to liquidation with the attendant possibility that the creditor will get less.

C. Tax Cases

The Loveridge court noted that “most of the Chapter 13 opinions [on interest rates] deal with creditors secured by liens on cars or tax creditors.” The court was right to distinguish Chapter 13 tax cases from Loveridge. The Internal Revenue Service and other taxing authorities are not bound by the same constraints or motivated by the same goals as private creditors. Therefore, tax cases should not be controlling precedent against nontax creditors like Northwestern.

Section 1129 implicitly recognizes the special nature of tax claims. Section 1129(a)(9)(C) separately deals with tax claims. While section 1129(a)(9)(C), like section 1129(b), contains the phrase “values as of the effective date of the plan,” cases under section 1129(a)(9)(C) have little precedential value to cases under section 1129(b). Similarly, Chapter 13 cases applying section 1325(a)(5) to tax claims should not be controlling in either Chapter 11 or Chapter 13 cases involving nontax claims.40

37. See supra note 22 and accompanying text.
39. 36 Bankr. at 168.
40. In bankruptcy cases, the Internal Revenue Service has been vigilant and reasonably successful in demanding a present value discount based on § 6621 of the Internal Revenue Code, which governs the interest charge on delinquent taxes. See, e.g., In re Fi-Hi Pizza, Inc., 40 Bankr. 258 (Bankr. D. Mass. 1984) (Chapter 11 proceeding); In re Stafford, 24 Bankr. 840 (Bankr. D. Kan. 1982). Nonetheless, perhaps § 6621 should not be used in bankruptcy to determine the “value, as of the effective date of the plan” of tax claims. In re Fisher, 29 Bankr. 542 (Bankr. D. Kan. 1983), makes a strong argument against such use:
D. Uniform Interest Rate for All Cases

The Loveridge court’s final reason for not following Chapter 13 case law on “value, as of the effective date of the plan” is that many Chapter 13 cases on “value, as of the effective date of the plan” attempt to set a uniform interest rate to be applied in all cases. Because of the $350,000 secured debt limit imposed by section 109(e), Chapter 13 cases will always involve relatively small dollar amounts. For reasons of administrative convenience and financial necessity, many jurisdictions use a uniform interest rate in applying section 1325(a)(5). Courts that utilize this constant rate make little or no distinction between the types of claims or the feasibility of the proposed plan.

Whether this uniform rate approach is appropriate even in Chapter 13 cases is questionable. The risks that a creditor incurs in waiting for payment should be a factor in determining whether the proposed periodic payments have a “value, as of the effective date of the plan” of the allowed amount of such claim. Although plans must meet feasibility standards, thus signifying that the bankruptcy court has determined that the plan likely will succeed, “some plans are more feasible than others.” Therefore, even a Chapter 13 court should build the secured creditors’ risks of loss into interest rate determinations on a case by case basis.

While considerations of convenience and economy might, nonetheless, offer some justifications for disregarding differences in creditor risk in some Chapter 13 cases, they are not applicable in most Chapter 11 cases. A Chapter 11 case can involve creditors with single secured claims far larger than the total amount of secured claims permitted in Chapter 13. Chapter 11’s requirements of creditors’ committees and creditors’ voting on plans also indicate that considerations of convenience and economy are less compelling in Chapter 11 than in Chapter 13.

Judge Clark in Loveridge concluded his comparison of Chapter 13 cases on “value, as of the effective date of the plan” with

The IRS does not set its section 6621 rate of interest based on any of the advocated factors such as duration, collateral, and risk of default. The IRS has determined that its rate of interest must be high enough to deter tax evasion, restrict creative tax avoidance, and to compel timely tax payment and reporting.

Id. at 545.

36 Bankr. at 168.
Chapter 11 cases by stating: “The Chapter 13 opinions are not the last word on present value issues in Chapter 11 cases. Put simply, the Chapter 13 opinions should not inspire courts to avoid hard thinking about present value issues in Chapter 11 cases.” While the Loveridge opinion provides support for this statement, it also provides support for the statement that Chapter 13 opinions are not the last word on present value issues in Chapter 13 cases. The present Chapter 13 opinions should not prevent courts from hard thinking about present value in Chapter 13 cases. Many of the reasons that the Loveridge court gave for not following Chapter 13 present value cases in Chapter 11 cases undercut the validity of the court’s assumptions about Chapter 13, not the applicability of an approach that is valid in Chapter 13 cases to Chapter 11 cases.

V. GROUNDS FOR RELIEF FROM THE AUTOMATIC STAY IN CHAPTERS 11 AND 13

The filing of any bankruptcy petition—Chapters 7, 11, or 13—triggers the automatic stay of section 362. Under section 362, a creditor is barred from proceeding against the debtor or its collateral without first obtaining permission from the bankruptcy court.

An important factor in assessing the impact of the automatic stay on a creditor is the time period that the automatic stay is in effect. Section 362(c)(2)(C) provides that the automatic stay automatically terminates when a discharge is granted. Thus, in a Chapter 11 case, the automatic stay ends when the plan is confirmed because confirmation of a Chapter 11 plan effects a discharge. Confirmation of a Chapter 13 plan, on the other hand, does not have this effect. Because the confirmation does not result in a discharge, it does not automatically terminate the automatic stay.

Frequently, in a Chapter 11 case, a year or two will pass between the filing of the bankruptcy petition and the confirmation of the plan. During this time period, the automatic stay bars the creditor from pursuing the debtor on prepetition obligations, and the debtor has no commitments to pay the creditor under the plan because it is not yet in place. Furthermore, the creditor cannot draw interest on its claim unless the value of the collateral securing its claim is greater than the amount of its debt. Except for the provision in section 506(b) for the over-secured creditor, the running of interest stops when the petition is filed.

44. 36 Bankr. at 168.
In a Chapter 13 case, it would be very unusual for a year to pass between the filing of the petition and confirmation of the plan. A Chapter 13 plan must be filed within fifteen days after the filing of the bankruptcy petition. In Chapter 13, unlike Chapter 11, the plan is not voted on by creditors. The delays in confirmation of a Chapter 13 plan are usually caused by the caseload of the court.

An aggrieved creditor can file a motion with the bankruptcy court requesting relief from the automatic stay. The relief can take the form of an end to the automatic stay or the imposition of conditions or restrictions on the continuation of the automatic stay. Section 362(d) sets out the grounds for this relief. The language of section 362(d) is the statutory language that controls motions for relief from the automatic stay in both Chapter 11 and Chapter 13 cases. While the statutory language is the same, whether courts should interpret the language of section 362(d) similarly in Chapter 11 and Chapter 13 cases is open to question.

A. Section 362(d)(1)

Section 362(d)(1) provides for relief from the automatic stay "for cause." "Cause" is not statutorily defined. The statute does, however, provide an example of "cause": "the lack of adequate protection of an interest in property of such party in interest." Many Chapter 11 and Chapter 13 cases have applied this language to requests for relief from stay by creditors with secured claims. That the adequate protection requirement is directed to a secured creditor's interest in its collateral, not its interest in the repayment of the underlying debt now seems well settled. It is not, however, well settled what interest in the collateral is to be adequately protected, or what is required to adequately protect that interest. Some of the leading cases addressing these issues concern Chapter 11. The question here considered is the extent to which this Chapter 11 case law should be followed in Chapter 13 cases concerning section 362(d)(1).

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46. Assume, for example, that D, who is now in bankruptcy, owes C $320,000 and this $320,000 debt is secured by equipment with a value of $110,000. Section 362(d)(1) requires adequate protection of C's interest in the $110,000 of collateral, but does not protect C's right of repayment of the $320,000 debt.
1. Opportunity Costs

A number of recent Chapter 11 cases have considered whether adequate protection includes compensation for lost opportunity costs. Assume, for example, that $D$ owes $C$ $370,000 and the debt is secured by collateral with a stable value of $110,000. $C$ argues that, but for bankruptcy and the automatic stay, it would: (i) foreclose on its collateral, (ii) sell the collateral for $110,000, (iii) reinvest the $110,000 of proceeds, and (iv) earn and be paid interest on the $110,000. $C$ thus contends that one of the costs of the stay is this lost opportunity, and that its rights in the collateral are not being adequately protected unless it is compensated for this loss.

Most of the bankruptcy courts that have considered such arguments have rejected them. Recently, however, the Ninth Circuit became the first circuit court to consider the opportunity cost issue. The Ninth Circuit held in In re American Mariner Industries, Inc. that adequate protection does include compensation for lost opportunities. The case involved facts very similar to those outlined in the above hypothetical: a Chapter 11 debtor and a partially secured creditor whose "collateral was not deprecating." The creditor claimed that its interest in the collateral would be adequately protected as contemplated by section 362(d)(1) only if it received periodic payments equal to its prospective return from

49. 734 F.2d 426 (9th Cir. 1984).
50. Id. at 428. In American Mariner, Crocker National Bank was an undersecured creditor with a debt of $370,000 secured by $110,000 of collateral. Crocker moved for adequate protection after American Mariner filed its petition. Crocker alleged that, because it had a state law right to seize and sell the collateral, the automatic stay prevented it from earning interest on the proceeds of the sale of collateral. The bankruptcy court found that the collateral was not deprecating and was necessary for an effective reorganization. A divided bankruptcy appellate panel affirmed the lower court's rejection of adequate protection for lost opportunity costs. 27 Bankr. 1004 (Bankr. 9th Cir. 1983). The debtor had offered to pay "interest on the value of the collateral" of $1770 per month. The bankruptcy court conditioned the continuation of the stay on such payment, stating: "Although I hold that no interest is due and although no evidence of economic depreciation has been presented, I find that the $1770 per month is adequate protection for any depreciation or depletion of the collateral that may occur." In re American Mariner Indus., Inc., 10 Bankr. 711, 714 (Bankr. C.D. Cal. 1981). Crocker appealed. The Ninth Circuit remanded the case with orders that the debtor structure some proposal that would adequately protect Crocker's interest. In re American Mariner Indus., Inc., 734 F.2d 426, 435 (9th Cir. 1984).
the reinvestment of the liquidation value of the collateral. Both the bankruptcy court\textsuperscript{51} and a divided bankruptcy appellate panel\textsuperscript{52} rejected this contention. The Ninth Circuit reversed and remanded, holding that the creditor is “entitled to compensation for the delay in enforcing its rights during the interim between the petition and the confirmation of the plan.”\textsuperscript{53}

In reaching this holding, the Ninth Circuit considered: (i) the phrase “indubitable equivalent,” which appears in section 361(3)’s list of examples of adequate protection; (ii) Judge Hand’s opinion using the language “indubitable equivalence” to define adequate protection in \textit{In re Murel Holding Corp.},\textsuperscript{54} a case under section 77B of the Bankruptcy Act of 1898; (iii) the use of the phrase “indubitable equivalent” in section 1129(b)(2)(A)(iii); and (iv) bankruptcy court decisions rejecting opportunity costs arguments in Chapter 11 cases.\textsuperscript{55} The Ninth Circuit’s opinion in \textit{American Mariner} does not mention Chapter 13 or consider Chapter 13 authority.\textsuperscript{56}

\textsuperscript{52} 27 Bankr. 1004 (Bankr. 9th Cir. 1983).
\textsuperscript{53} 734 F.2d at 435.
\textsuperscript{54} 75 F.2d 941 (2d Cir. 1935) (Hand, J.).
\textsuperscript{55} \textit{Murel} concerned a proposed plan for repaying the mortgagee of an apartment house. The debtors’ plan proposed that the mortgagee forego amortization payments and extend the due date of the mortgage while the debtors renovated the apartment house to make it more readily leasable. After the mortgagee rejected the plan, the court had to decide whether or not the owner’s plan provided adequate protection before the court could confirm the plan over the mortgagee’s objection. Judge Hand explained the concept of adequate protection:

\begin{quote}
It is plain that “adequate protection” must be completely compensatory; and that payment ten years hence is not generally the equivalent of payment now. Interest is indeed the common measure of the difference, but a creditor who fears the safety of his principal will scarcely be content with that; he wishes to get his money or at least the property. We see no reason to suppose that the statute was intended to deprive him of that in the interest of junior holders, unless by substitute of the most indubitable equivalence.
\end{quote}

\textit{Id.} at 942 (emphasis added). The \textit{Murel} court rejected the plan because it determined that the plan had little hope of success and thus did not afford the mortgagee adequate protection. \textit{Id.} at 943.

Judge Hand’s explanation of “adequate protection” was given new significance by congressional reports indicating that “[t]he indubitable equivalent language is intended to follow the strict approach taken by Judge Learned Hand in \textit{In re Murel Holding Corp.}, 75 F.2d 941 (2d Cir. 1935).” \textit{S. Rep. No. 989, 95th Cong., 2d Sess. 127, reprinted in 1978 U.S. Code Cong. & Ad. News 5787, 5913.}

\textsuperscript{56} \textit{See supra note 47.}

56. Consider the consequences of applying the \textit{American Mariner} rule to the most common Chapter 13 adequate protection fact situation. \textit{D}, the Chapter 13 debtor, owes \textit{C} $10,000 on her car note. \textit{C} has a perfected security interest in \textit{D}’s car. The car has a value of $6000 and this value is declining at a rate of $300. \textit{C} files a motion requesting relief from the
Since the *American Mariner* decision was decided on June 4, 1984, several Chapter 11 cases have relied on *American Mariner* to hold that when the automatic stay prevents a creditor from repossessing its collateral, the creditor is entitled, under the concept of adequate protection, to compensation for this delay in enforcing its rights. At least one Chapter 11 case has expressly rejected *American Mariner*. To date, no reported Chapter 13 case has considered *American Mariner*.

Is there any reason to limit *American Mariner* to Chapter 11 cases? The Ninth Circuit looked to the “indubitable equivalent” language in section 361(3) in interpreting the phrase “adequate protection” in section 362(d)(1). Section 361(3), like section 362(d)(1), applies in Chapter 13 cases as well as Chapter 11 cases. The argument that *American Mariner* should not be followed in either Chapter 11 or Chapter 13 cases is easier to make than the argument that *American Mariner* should be followed only in Chapter 11 cases. A first difficulty *American Mariner* presents lies in distinguishing “opportunity costs” from postpetition interest. Arguably, *American Mariner* creates a conflict with section 506(b)’s dictate that only fully secured claims accrue interest during the period between the filing of the petition and the confirmation of the plan.

How is opportunity costs compensation different from interest? While the *American Mariner* opinion avoids using the term “interest,” it acknowledges that “monthly interest payments at the market rate on the liquidation value of the collateral” is a permissible form of adequate protection for opportunity costs. A later opportunity costs decision, *Grundy National Bank v. Tandem Mining Corp.*, is more direct. It relies on *American Mariner* to hold that a creditor is entitled to interest.

A second problem that *American Mariner* creates is the possi-
bility that a creditor that is only partially secured will be treated more favorably than a creditor that is fully secured. Under American Mariner, a creditor whose debt is partially secured is entitled to periodic payments to cover lost opportunity costs. Under section 506(b), the fully secured creditor's claim will accrue postpetition interest, but the fully secured creditor will not immediately receive this postpetition interest. Section 506(b) does not contemplate that holders of fully secured claims will be paid $X$ dollars each month. Instead, the fully secured creditor's claim will increase by $X$ dollars each month.

Does American Mariner contemplate that fully secured creditors also must receive opportunity cost payments as a part of adequate protection? Has a creditor whose claim is continuing to draw interest been deprived of an opportunity cost? At least one post-American Mariner decision from a bankruptcy court in the Ninth Circuit has answered the latter question in the negative and denied the opportunity cost claim of a fully secured creditor. This holding means that a partially secured creditor, but not a fully secured creditor, can demand periodic payments as a condition to the continuation of the automatic stay.

2. Role of the Bankruptcy Judge in Adequate Protection Litigation

Neither the Bankruptcy Code nor the Bankruptcy Rules specifically describe the role that the bankruptcy judge is to play in section 362(d)(1) litigation in which the issue is whether the creditor seeking relief from the automatic stay is adequately protected. There is, however, some relevant legislative history. Both the House report and the Senate report accompanying the bills that became the Bankruptcy Reform Act of 1978 state that the Bankruptcy Code does not require courts to provide an adequate protection proposal. The court's role is only to determine whether the trustee's or debtor's proposal meets the "adequate protection" standard.

63. See In re Sun Valley Ranches, Inc., 43 Bankr. 641 (Bankr. D. Idaho 1984) (Williams, Mag.). In Sun Valley Ranches, the creditor's first petition for relief was denied on the basis of the bankruptcy appellate panel's decision in American Mariner, which the Ninth Circuit reversed. The Sun Valley court denied the opportunity cost claim because it reasoned that a fully secured creditor with an equity cushion is already adequately protected. The court concluded that American Mariner intended to provide only the undersecured creditor with adequate protection similar to that given to fully secured creditors under § 506(b).

Unfortunately, the legislative reports do not indicate what should happen if the court decides that the protection provided is not adequate. What if, for example, a Chapter 11 or Chapter 13 debtor proposes monthly payments of \( X \) dollars to cover the depreciation of a creditor's collateral, but the bankruptcy court decides that \( X \) dollars is not adequate? Should the bankruptcy court terminate the automatic stay or condition the continuation of the automatic stay on payments in an amount that the court deems adequate?

Recently, in *In re Irving A. Horns Farms, Inc.*, a Chapter 11 case, the bankruptcy court answered this question by granting the motion to lift the stay and stating: "It is not the Court's duty to fashion adequate protection." In *Horns* the debtor did not make a specific adequate protection proposal; in other words, the debtor never offered any additional collateral or payments to compensate for the decreasing value of the creditor's interest in the debtor's property. Perhaps a court will be more willing to modify a debtor's adequate protection proposal. Indeed, a Utah bankruptcy court in *In re Alyucan Interstate Corp.* relied on the word "modify" to suggest a more active role for the bankruptcy judge in section 362(d)(1) litigation. The *Alyucan* court concluded: "This result [courts actively fashioning protection for creditors] may be inevitable given the exigencies and informalities of relief from stay proceedings. Indeed it grows out of the language of section 362(d) which mandates relief such as 'modifying or conditioning' the stay."

A number of arguments support the proposition that, at least in Chapter 13 cases, the bankruptcy court should take a more active role in adequate protection litigation. The differences in dollar amounts at stake suggest that often there will be differences in the quantity and quality of debtor representation in Chapter 11 and

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This section [section 361] specifies the means by which adequate protection may be provided . . . [but, to avoid] placing the court in an administrative role[,] . . . does not require the court to provide it . . . . Instead, the trustee or debtor in possession [or the creditor] will provide or propose a protection method. If the party that is affected by the proposed action objects, the court will determine whether the protection provided is adequate.

*Id.*

66. *Id.* at 838.
68. *Id.* at 809 n.12; see also *In re Pleasant Valley, Inc.*, 6 Bankr. 13, 17-18 (Bankr D. Nev. 1980) (court provided a number of specific terms and conditions for the debtor to meet in satisfying the "adequate protection" standard).
Chapter 13 cases. Should a Chapter 13 debtor lose her car because the general practitioner representing her is unaware that American Mariner means that adequate protection payments must cover both depreciation and opportunity costs even though the debtor is able and willing to make such payments? Moreover, the Bankruptcy Code suggests that the court take a more active role in Chapter 13 cases: a Chapter 11 plan is reviewed and passed on by both creditors and the bankruptcy court, but a Chapter 13 plan is reviewed and passed on only by the bankruptcy judge.

B. Section 362(d)(2)

Section 362(d)(2) provides an alternative basis for relief from the automatic stay. A secured creditor is entitled to relief from the stay if it can either establish “cause” under section 362(d)(1) or satisfy the requirements of section 362(d)(2). The issues under section 362(d)(2) are whether the debtor has any equity in the encumbered property and whether the encumbered property is “necessary to an effective reorganization.”

1. Applicability of Section 362(d)(2) in Chapter 13 Cases

No court has questioned whether section 362(d)(1) applies in Chapter 13 cases. Several courts, however, have refused to apply section 362(d)(2) in Chapter 13 cases. In refusing to apply section 362(d)(2) in Chapter 13 cases, the courts have looked to the word “reorganization” in section 362(d)(2)(B). “Reorganization” is the term used for the title of Chapter 11. While there can be a rehabilitation or debt adjustment in Chapter 13, there cannot be “reorganization.” These courts thus have reasoned that section 362(d)(2) only applies in Chapter 11 cases.

Legislative history also provides some support for the view that section 362(d)(2) does not apply in Chapter 13 cases. This subsection was inserted by the Senate during its deliberations on

71. See Youngs, 7 Bankr. at 69; Feimster, 3 Bankr. at 11.
the Bankruptcy Reform Act of 1978. As originally drafted, section 362(d)(2) stated, "property is not necessary to an effective reorganization of the debtor if it is real property in which no business is being conducted by the debtor other than the business of operating the real property and the activities incident thereto." This draft suggests that Congress was concerned about business cases. Because Chapter 13 cases normally do not involve businesses, it can be argued that this draft implies that Congress did not intend section 362(d)(2) to apply to Chapter 13.

Notwithstanding the statutory language, the legislative history, and the problems of applying the statute, the majority view is that section 362(d)(2) does apply to Chapter 13 cases. The majority view cases have relied primarily on section 103(a) of the Bankruptcy Code, which makes all of Chapter 3 applicable in Chapter 13 cases.

2. What is "Necessary"

As previously mentioned, before granting relief from the automatic stay under section 362(d)(2), the court must determine that the property at issue is not "necessary" to an effective reorganization. "Necessary" is not defined in the Bankruptcy Code and may have a different meaning in Chapter 11 cases than it has in Chapter 13 cases. The rest of this section explores the foundation of these different meanings.

Assume that ACME, Inc., filed a Chapter 11 petition. At the time of the filing, the airline had sixty-six planes. S, a creditor with

73. Id. (emphasis added).

At least one bankruptcy court has based its conclusion that § 362(d)(2)(B) has no application to Chapter 13 cases on policy grounds. In re Garner, 13 Bankr. 799 (Bankr. S.D.N.Y. 1981). The bankruptcy court reasoned that because § 362(g) shifts the burden of proof to the debtor on the issue of the property's necessity and because the debtor rarely could prove the necessity of nonincome producing property, applying § 362(d)(2) conflicts with the remedial purpose of Chapter 13. In reversing this holding in In re Garner, 18 Bankr. 369, 370-71 (S.D.N.Y. 1982), the district court stated that the "necessary to an effective reorganization" standard must have an entirely different meaning in rehabilitation cases. The district court found that the "stay against foreclosure on residential property might be lifted where the debtor's present assets or prospects and the plan would not suffer materially." Id. at 371; see also Nimmer, Real Estate Creditors and the Automatic Stay: A Study in Behavioral Economics, 1983 Ariz. St. L.J. 281, 320 (noting the problems in applying the "necessary" standard to residential property).

74. See supra note 73.

75. See, e.g., In re Mellor, 734 F.2d 1396 (9th Cir. 1984); In re Million, 39 Bankr. 136 (Bankr. S.D. Ohio 1984); see also H. Sommer, Consumer Bankruptcy Law and Practice 55-56 (1982).

a lien on seven of the planes, files a motion requesting relief from the stay under section 362(d)(2). Should the bankruptcy court wrestle with the question of whether ACME needs all sixty-six planes, in other words, whether it can reorganize with only fifty-nine planes?

To date, bankruptcy courts have not dealt with such questions in reported Chapter 11 cases. Instead, the courts seem to assume that a Chapter 11 debtor has discretion in choosing which property to use in its reorganization effort. Consider, for example, *In re Mickler*, a Chapter 11 case involving a request to lift the stay on raw land that the debtor occasionally used for farming and cattle grazing. In denying the creditor's motion, the court stated:

> Although the Court is not overly persuaded by the Debtors' need to use the subject property . . . the Court is persuaded that . . . the Debtors should be able to select the assets that should be sold and which to retain so long as the rights of the parties are not significantly impaired and their interest is adequately protected.

Other courts have suggested that, in business reorganization cases, "necessary" simply means income producing or income related. Under this latter test, a creditor with a lien on one of ACME's planes could obtain relief from the stay under section 362(d)(2) only for those planes that ACME is not using.

Another issue bankruptcy courts must address in Chapter 11 section 362(d)(2) litigation is whether section 1121(b) requires that the court delay 120 days before making any 362(d)(2) determinations. Under section 1121(b), only the debtor can file a plan during the first 120 days of the Chapter 11 case. An early judicial determination that property is not necessary to an effective reorganization would seem inconsistent with this period of exclusivity.

Bankruptcy courts have been willing to question a Chapter 13 consumer debtor's claim that encumbered property is necessary. For example, in *In re Jones*, the court granted Chrysler Credit Corporation's motion to lift the stay so that it could repossess the debtor's 1976 Chevrolet Monte Carlo. The debtor owed $2546 to Chrysler on the car, which had a value of $1500 to $1800. The court concluded that the debtor had failed to show that the automobile was necessary "having found that public transportation and

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78. Id. at 633.
his stepfather's automobile are available to Debtor."

Most of the reported Chapter 13 cases under section 362(d)(2) involve home mortgages. In some of these cases, the courts analyzed "necessary" by determining whether the property is essential to the debtor's production of income. These courts concluded that a house used solely as a residence is never necessary. Other courts summarily conclude that, so long as the house is used as the debtor's residence, it is "necessary."

Recently, in In re Gregory, the bankruptcy court for the Middle District of Tennessee had to decide the meaning of "necessary" as applied to a debtor's home in a Chapter 11 case. The debtors in Gregory were wage earning consumers who filed for Chapter 11 relief "to save our house." By filing under Chapter 11 rather than Chapter 13, the debtors hoped to propose a plan that would restructure their home mortgage payments. Before a plan was filed, the Federal Deposit Insurance Corporation (FDIC) as mortgage holder filed a motion requesting relief from the automatic stay. The debtors offered monthly payments of $500 to the FDIC. The parties stipulated that the debtors had no equity in the encumbered property, that the debtors offer of $500 monthly payments was adequate protection, and that comparable housing was available for $350 a month. Under these facts, the bankruptcy court held that the property was not necessary to an effective reorganization.

In arriving at this holding, the Gregory court stated that though residential property does not have to be directly related to the production of income to be held "necessary" within the contemplation of section 362(d)(2), the debtor must nonetheless prove a genuine need for the property. Thus, if the court finds that a rented apartment meets the debtor's Chapter 11 needs, the house

81. Id. at 142.
82. See generally Zaretsky, Commentary, Some Limits on Mortgagees' Rights in Chapter 13, 50 BROOKLYN L. REV. 433 (1984) (discussing two recent Second Circuit cases concerning Chapter 13 debtors and secured mortgage creditors that have upheld a policy of debtor protection); Comment, Home Foreclosures Under Chapter 13 of the Bankruptcy Reform Act, 30 UCLA L. REV. 637 (1983) (exploring Chapter 13 home foreclosure issues).
86. Section 1322(b)(2) of Chapter 13 forbids the modification of a "security interest in real property that is the debtor's principal residence."
is not necessary. The *Gregory* opinion requires that the bankruptcy court balance the costs and determine whether other living arrangements are fungible with the debtor's needs.\(^8\)

The *Gregory* approach of testing the debtor's minimum living requirements arguably finds further support in a 1984 amendment to Chapter 13—section 1325(b). Under this section, a Chapter 13 debtor who proposes a composition plan must commit all of her "disposable income" to the repayment of prepetition debts.\(^8\) Forcing a Chapter 13 debtor to give up her home if there is a less costly housing alternative increases the disposable income available to satisfy creditors' claims.

While *Gregory* was not a Chapter 13 case, the court looked to Chapter 13 case authority and seemed to suggest an approach to use in both Chapter 13 and Chapter 11 *consumer* cases.\(^9\) If "necessary" is to be given a different meaning in different kinds of cases, it is more reasonable to classify cases on a "consumer debtor/business debtor" basis rather than on a "Chapter 11 case/Chapter 13 case" basis.

VI. CLASSIFICATION OF "SUBSTANTIALLY SIMILAR" CLAIMS

Both Chapter 11 and Chapter 13 have one critical point in common: they both use a plan that determines the amount and form of distribution to various creditors. Both chapters provide that the plan can classify claims\(^9\) and pay some classes of claims

87. See 39 Bankr. at 411. The opinion provides: This court believes that a debtor's home is necessary to an effective reorganization only if the property is not fungible with other living arrangements meeting the debtor's minimum living requirements . . . . Measuring fungibility against the debtor's minimum living requirements is consistent with the congressional use of the word "necessary" and allocates the burden to the debtors to demonstrate genuine need for the property. *Id.* (emphasis in original).


more and sooner than others. Cases under both chapters place secured claims in separate classes. Both chapters also require that unsecured claims which are not "substantially similar" be placed in different classes. Neither chapter, however, clearly indicates whether unsecured claims that are "substantially similar" can be placed in different classes. This part of the Article focuses on the specific classification issue of the limits on a Chapter 11 or Chapter 13 debtor's discretion in placing unsecured claims in different classes. More specifically, when a debtor's plan provides for more than one class of unsecured claims, whether it has to establish that the unsecured claims in each of the classes are different somehow from the unsecured claims in the other classes.

A. Differences in the Significance of Classification of Claims in Chapter 11 and 13

While many classification characteristics and questions are common to Chapters 11 and 13, the two chapters contain differences in the significance attached to the classification of claims. In Chapter 11, the classification of claims can affect not only what creditors receive under a plan but whether a plan can successfully pass through the approval process contemplated by the Bankruptcy Code. Both creditors and the bankruptcy judge are involved in this approval process.

Creditors of a Chapter 11 debtor receive a copy of a disclosure statement containing "adequate information" about the plan. The creditors then have the opportunity to vote on the plan. To determine whether a sufficient number of creditors have accepted the plan, the votes are counted by class—"two-thirds in amount and more than one-half in number of the allowed claims of such class." If the requisite majority of the class accepts the plan, all holders of claims within the class are bound by the vote. At least one class of claims must vote to accept the plan. When one class accepts the plan but one or more classes dissent, the bankruptcy

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92. Id. § 1126(c) (emphasis added).
93. Id. § 1141(a).
94. Id. § 1129(a)(10).
judge may apply section 1129(b) and force the plan on the dissenting classes. Before effecting this "cram-down," the court must find that the plan is "fair and equitable" with respect to each dissenting class and does not "discriminate unfairly" against any dissenting class.

In contrast, Chapter 13 creditors do not vote on the plan, and the tests the judge applies in confirming a plan focus on individual claims rather than classes of claims. Accordingly, classification has a different and greater significance in Chapter 11 than in Chapter 13. In Chapter 11, and only Chapter 11, a debtor might try to classify claims to manipulate the creditor acceptance process. If a Chapter 11 debtor, \( D \), believes that creditors \( X \) and \( Y \) will reject any plan that provides for less than full payment, \( D \) might try to place \( X \)'s claim and \( Y \)'s claim in different classes and include a sufficient number of "friendly creditors" in each class to meet the approval standards of section 1126. This problem is unique to Chapter 11.

B. Code Provisions

As noted above, the Bankruptcy Code does not expressly deal with the question of whether a Chapter 11 or Chapter 13 plan can place similar unsecured claims in different classes.

Section 1122 governs classification in Chapter 11 plans. Section 1122(b) authorizes the segregation of all small claims into a single class if "reasonable and necessary for administrative convenience."\(^95\) Section 1122(a) provides the general test for determining whether a claim \( C \) can be included within a class: all claims within a class must be "substantially similar" to other claims in that class. Paragraph (a) does not provide any test for determining whether a claim \( C \) must be included within a class. No language in section 1122 limits the discretion of the drafter of the plan in placing "substantially similar" claims in different classes.\(^96\)

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95. *Id.* § 1122(b). Typically, a Chapter 11 plan provides for full cash payment of all claims of \( X \) dollars or less. Thus, this class of claims is unimpaired by reason of § 1124(3) and is conclusively presumed to have accepted the plan under § 1126(f). Furthermore, § 1126(f) excuses the debtor from sending disclosure statements to and soliciting plan acceptances from the creditors in that class.

96. To illustrate, assume that \( X, Y, \) and \( Z \) are creditors of Chapter 11 debtor, \( D \). If \( D \)'s Chapter 11 plan places all three creditors' claims in the same class, § 1122(a) controls. It is clear from § 1122(a) that \( D \) cannot place the claims of \( X, Y, Z \) in a single class unless all three claims are "substantially similar"—whatever that means. If, however, \( D \)'s Chapter 11 plan places each creditor's claim in a separate class, § 1122(a) does not control. What limits \( D \)'s discretion in placing claims in separate classes is not clear from § 1122(a).
Section 1322 governs classification of unsecured claims in Chapter 13 plans. Section 1322(b)(1) expressly incorporates section 1122 and adds the requirement that the plan “may not discriminate unfairly against any class so designated.” Section 1122 contains no “discriminates unfairly” test. This phrase, however, does not appear in section 1129(b), but this “discriminates unfairly” test only applies in Chapter 11 cases that have a dissenting class.97

The effect of the “discriminates unfairly” test on a debtor’s discretion in placing “substantially similar” claims in different classes raises a further question. If a debtor’s Chapter 13 plan places the claims of different unsecured creditors in different classes and provides for different treatment to each class, the plan is obviously discriminatory with respect to these claims—is that level of discrimination unfair?

C. Case Law Under the 1898 Act

Some legislative history suggests that claims classification cases under the Bankruptcy Act of 1898 will be helpful in answering claims classification questions under the Bankruptcy Code. Section 1122 of the Bankruptcy Code is identical to section 1122 of H.R. 8200. According to the House committee report that accompanied H.R. 8200, “[t]his section codifies current case law surrounding the classification of claims.”98

Chapter XIII of the 1898 Act was the predecessor to Chapter 13 of the Bankruptcy Code. Unfortunately, there is no case law “surrounding the classification of claims” under Chapter XIII of the Bankruptcy Act of 1898 because Chapter XIII did not provide for the classification of claims. Section 646 of the Bankruptcy Act of 1898 required that the Chapter XIII plan deal with unsecured claims “generally,”99 and “generally” was commonly interpreted to require pro rata payment to all unsecured creditors.100

Chapters X, XI, and XII were the forerunners of Chapter 11 of the Bankruptcy Code. Although each of these chapters permitted classification of claims, there was very little litigation or secondary writing about classification of claims.101 Furthermore, each

97. See supra text following note 94.
100. See 3 D. Cowans, BANKRUPTCY LAW AND PRACTICE § 1127, at 433 (2d ed. 1978).
101. See Note, Classification of Claims in Debtor Proceedings, 49 Yale L.J. 881
of these chapters contained differences in their classification provisions that prevent them from being completely analogous to Chapter 11.

Section 197\textsuperscript{102} of the Bankruptcy Act of 1898 contained the classification criteria for Chapter X and provided, in part: "For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock."\textsuperscript{103} Section 197 of the Bankruptcy Act of 1898, unlike section 1122 of the Bankruptcy Code, gave the bankruptcy court independent power to designate classes. The bankruptcy judge cannot classify claims under the Bankruptcy Code. The present court's only control over classification of claims is to withhold confirmation under section 1129(a)(1) when the classification in the plan does not comply with the applicable provisions of the Bankruptcy Code. Nonetheless, the general operation of Chapter X was similar to Chapter 11. In Chapter X, like Chapter 11, creditors voted on the plan;\textsuperscript{104} in Chapter X, unlike Chapter 11, the court appointed a trustee in every case.\textsuperscript{105}

Section 357(1) of the Bankruptcy Act of 1898, which provided the classification scheme for Chapter XI, stated that a Chapter XI plan could include provisions for "the division of such debts into classes and the treatment thereof in different ways or upon different terms."\textsuperscript{106} Section 357 thus omitted the "nature of their respective claims" language found in section 197. The general operation of Chapter XI was similar to Chapter 11. In Chapter XI, like Chapter 11, creditors voted on the plan by class;\textsuperscript{107} in Chapter XI, unlike Chapter 11, only the debtor could propose or modify the plan.\textsuperscript{108} A Chapter XI debtor thus could negotiate for creditor approval of its plan on the basis of "accept on these terms or it's liquidation."

Section 452 of the Bankruptcy Act of 1898, which provided the classification scheme for Chapter XII, permitted classification of Chapter XII creditors "according to the nature of their respec-

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\textsuperscript{103} Id.
\textsuperscript{104} Id. § 579 (repealed 1978).
\textsuperscript{105} Id. §§ 556 (repealed 1978).
\textsuperscript{106} Id. § 757 (repealed 1978).
\textsuperscript{107} Id. § 762 (repealed 1978).
\textsuperscript{108} Id. § 706(1) (repealed 1978).
tive claims.” Therefore, the Chapter XII classification language, like the Chapter X classification language, included the “nature of their respective claims” limitation. Chapter XII, however, could be used only when the primary purpose of the reorganization was the modification of the rights of creditors whose claims were secured by real property: accordingly, classification of unsecured claims generally was not an issue in Chapter XII cases.

None of the various statutory standards for classification of claims under the Bankruptcy Act of 1898 expressly deals with the limits that govern a debtor’s decision to separate claims into different classes. Reported decisions under the 1898 Act, however, do speak to this issue. A number of these cases apply the test from the early Bankruptcy Act case of In re Hudson-Ross, Inc.,—any differences in treatment of unsecured claims must be just and reasonably necessary to effectuate the plan.

In one of the last 1898 Act cases on classification, In re Winston Mills, Inc., the bankruptcy court followed a more liberal approach to classification. The Winston Mills opinion describes the classification process as a “product of delicate negotiations taking place in the dialogue between a debtor and its creditors.” The court reasoned that the requirement that a plan be accepted by a statutory majority of the creditors in each class afforded the separate classes sufficient protection. The court, however, specifically noted that the classification scheme was not invidious, thus suggesting some minimum level of review was appropriate. The Winston Mills opinion concludes with the observation that the same approach to classification should and would be taken under

109. Id. § 852 (repealed 1978).
110. Id. § 806 (repealed 1978).
114. 1 COLLIER BANKR. CAS. 2d (MB) 121 (Bankr. S.D.N.Y. 1979).
115. Id. at 127.
116. Id. at 128. The opinion provides:

What emerges plainly from the appraisal of the Chapter XI symmetry is that a debtor’s plan is the product of delicate negotiations taking place in the dialogue between a debtor and its creditors. . . . It is not unknown, therefore, that a debtor will deal with its trade creditors in one way, its union creditors in another, its institutional debt in still another and so on. It is up to the debtor and all its creditors to decide the extent to which the good graces of the trade creditors or the union will be needed if the rehabilitated debtor is to survive as a viable commercial entity. . . .

Id. at 127-28.
the Bankruptcy Code. While the court’s reliance on negotiations between the debtor and the creditor to control most classification abuses arguably is appropriate in Chapter 11 cases, such reliance does not seem applicable to Chapter 13 cases. Because Chapter 13 has no provision for creditor voting, the plan in Chapter 13 cases is far less likely to be the "product of delicate negotiations."

D. Case Law Under the Bankruptcy Code

Since the Bankruptcy Code became effective on October 1, 1979, few reported Chapter 11 cases have discussed the classification of unsecured claims issue. Several cases, however, denied confirmation of Chapter 11 plans because the plans placed unsecured claims in separate classes. One circuit court also has offered some dicta on this issue.

The plan in *In re Mastercraft Record Plating, Inc.*, divided unsecured claims into three classes: (1) claims under $20,000, (2) claims over $20,000, and (3) disputed claims. The plan treated the over $20,000 class and the under $20,000 class identically. In reviewing the adequacy of this plan, the court first found that the classification scheme failed to meet the requirements of section 1122(b) because it did not pay in full the claims under $20,000. The court next analyzed section 1122(a) and noted that its concern with placing similar claims in the same class carried with it the negative implication that similar claims normally should not be placed in different classes. Because it viewed all general unsecured claims as similar, the court denied confirmation of the plan. The *Mastercraft* opinion concludes this analysis by stating: "Classification cannot be used to divide like claims into multiple classes in order to create a consenting class so as to permit confirmation."

In *In re S & W Enterprise*, the Chapter 11 plan placed all unsecured claims of less than $1000 in a separate class. There were two claims in this class; there was only one unsecured claim of more than $1000. In rejecting confirmation of the plan, the court focused on the "reasonable and necessary" requirement in section 1122(b). The court also noted by way of dictum that "the manipulation of unsecured claims . . . for the sole purpose of complying with the voting requirement of section 1129(a)(10) shall not be
tolerated.”¹²¹

The First Circuit, in Granada Wines, Inc. v. New England Teamsters and Trucking Industry Pension Fund,¹²² reviewed a bankruptcy court’s order requiring the Chapter 11 debtor to pay to the appellee pension fund the same percentage as all other unsecured creditors. Although the plan had not placed the pension fund claim in a separate class, the debtor argued that the claim should be treated as if it were in a separate class and receive a reduced payment. In rejecting this argument, the First Circuit considered when unsecured claims can be placed in separate classes. Relying on case law under the 1898 Act, the court concluded: “Separate classifications for unsecured creditors are only justified ‘where the legal character of their claims is such as to accord them a status different from other unsecured creditors.’”¹²³

In Mastercraft, S & W, and Granada Wines, the courts were concerned with classification being used to manipulate the creditor voting requirements. In a sense, these cases present the easy classification issue—can a debtor base its classification on voting consideration.¹²⁴ Clearly, a debtor should not be able to gerrymander classification for voting purposes. (Remember that this will not be an issue in Chapter 13 cases). What the limitations on classification of claims are when there is no vote manipulations issue or concern remains unclear.

While there have only been a few reported Chapter 11 cases on classification, there are numerous reported Chapter 13 cases.¹²⁵ Two of the 1984 amendments to the Code, however, limit the precedential value of many of these cases. First, section 1322(b)(1) now expressly and specifically empowers a debtor to place debts that have a codebtor in a separate class. A Chapter 13 debtor who is proposing something less than full payment on all unsecured debts often will place any cosigned debts in a separate class and provide for full payment to that class. The section 1301 automatic stay against collection from codebtors on consumer debts is operative only to the extent that the debt is to be paid under the plan. If the

¹²¹ Id. at 634.
¹²² 748 F.2d 42 (1st Cir. 1984).
¹²³ Id. at 46 (quoting In re Los Angeles Land and Inv. Ltd., 282 F. Supp. 448, 454 (1968), aff’d, 447 F.2d 1366 (9th Cir. 1971) (an example of such a claim is a tax claim)).
¹²⁴ See generally Given & Phillips, supra note 90, at 735, 749-50 (arguing that courts must consider the voting power of claimants when reviewing classification schemes).
plan provides for less than full payment, the creditor may obtain relief from the stay and proceed against the codebtor. Most of the reported Chapter 13 classification cases concern debtor's efforts to place cosigned debts in a separate class—a nonissue after the 1984 amendments.

Second, section 1325(b) now requires that a Chapter 13 debtor who proposes a composition plan to her creditors commit all of her disposable income to the Chapter 13 plan. This amendment addresses a concern of some segments of the consumer credit industry that debtors were obtaining the substantial benefits of Chapter 13 while making insubstantial payments to creditors.\textsuperscript{126}

Section 1325(b) probably will not prevent low or zero payment plans to unsecured creditors in all cases. Unlike earlier proposals,\textsuperscript{127} section 1325(b) focuses on the amount that the debtor keeps for herself, rather than the amount that the creditor receives. If all of a debtor's income were "necessary to be expended for the maintenance or support of the debtor," such a debtor would have no disposable income and could file a zero payment plan and still comply with section 1325(b).

Although section 1325(b) may not have the intended effect of precluding Chapter 13 plans that propose low or no payment on unsecured claims, it may have an unintended effect on the approach that some courts take to the classification of claims issue. Previously, some court adopted the position that they should not impose restrictions on the discretion exercised by a Chapter 13 debtor in classifying claims. These courts reasoned that so long as a creditor receives as much as it would receive in a Chapter 7 liquidation case, it cannot complain because other creditors are receiving more.\textsuperscript{128} The courts derived this conclusion from section 1325(a)(4)'s requirement that creditors receive no less than the amount they would have received under Chapter 7 before the court could confirm a Chapter 13 plan.

Section 1325(b) undermines whatever limited validity this position had. Since in Chapter 13, a debtor is now statutorily obli-

\begin{footnotesize}
\textsuperscript{126} Shortly after the Bankruptcy Code became effective, a number of bankruptcy judges confirmed Chapter 13 plans that provided for low or no payments to unsecured claims. See, e.g., In re Beaver, 2 Bankr. 337 (Bankr. S.D. Calif. 1980); In re Marlow, 3 Bankr. 305 (Bankr. N.D. Ill. 1980).


\textsuperscript{128} See, e.g., In re Freeman, 28 Bankr. 74, 76 (Bankr. S.D. Miss. 1982), aff'd sub nom. Public Fin. Corp. v. Freeman, 28 Bankr. 77 (S.D. Miss.), aff'd in part, 712 F.2d 219 (5th Cir. 1983); In re Sutherland, 3 Bankr. 420, 422 (Bankr. W.D. Ark. 1980).
\end{footnotesize}
gated to devote all of her disposable income to her plan, a creditor is disadvantaged if another creditor receives a greater part of this disposable income.

Even though the 1984 amendments affect the precedential value of the holdings of many pre-1984 Chapter 13 classification cases, the opinion in *In re Kovich*¹²⁹ and a number of later cases suggest an approach to placing unsecured claims in separate classes that merits consideration in both Chapter 11 and Chapter 13 cases. When reviewing the debtor's classifications the court in *Kovich* considered the following four questions: (1) Is there a reasonable basis for the classification? (2) Is the debtor able to perform a plan without the classification? (3) Has the debtor acted in good faith in classifying claims? (4) How is the claim discriminated against being treated?¹³⁰ In essence, *Kovich* recognizes that the classification of claims presents the classic balancing issue: benefit versus detriment. Any bankruptcy court facing a classification issue should balance the extent to which the classification might help the debtor perform under the plan against the extent to which the classification disadvantages any class.

¹³⁰. *Id.* at 407.