ABI Journal: Problems in the Code column
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February 16, 2013

Separate Classification of Student Loan Debt in Chapter 13:
An Examination of the Conflict Between Sections 1322(b)(1) and (5)

Student loans, both public and private, are currently nondischargeable under § 523(a)(8) unless excepting the debt from discharge would impose an undue hardship on the debtor and the debtor's dependents. The present law is the product of a series of amendments to the Bankruptcy Code that parallels the development of the modern student loan industry.[1] These amendments have made § 523(a)(8) increasingly creditor-friendly, culminating with a 2005 amendment added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) extending nondischargeability to student loans made by private lenders.[2]

At the same time that discharging student loans has become more difficult, an enormous expansion in the amount of student loan debt has presented bankruptcy lawyers and judges with individual debtors who are genuinely unable to repay the full amount of their educational debt.[3] The tension between the restrictive language of the Code and the reality of their case load has

[1] The first provision limiting the discharge of student loan debt did not appear until 1976, when certain government-backed student loans were made nondischargeable under the former Bankruptcy Act for a period of 5 years after thedate the loan first became due. During this 5-year period, student loans continued to be dischargeable if disallowing the discharge would impose an undue hardship on the debtor or his dependents. These provisions were carried forward into the Bankruptcy Code of 1978, and the 5-year provision was expanded to include a wider array of educational loans (any educational loan funded, made, insured, or guaranteed by a governmental unit or funded by a nonprofit educational institution). The 5-year limit was increased to 7 years in 1990. The 7-year rule was eliminated in 1998, leaving undue hardship as the only avenue for the discharge of most educational debt. *See*, *e.g.*, Cox v. Hemar Ins. Corp. of Am. (*In re* Cox), 338 F.3d 1238, 1242-43 (11th Cir. 2003) (detailing the evolution of § 523(a)(8)).

[2] Pub. L. No. 109-8, § 220, 119 Stat. 23 (2005).

[3] *See*, *e.g.*, Carnduff v. United States Dept. of Educ. (*In re* Carnduff), 367 B.R. 120 (9th Cir. B.A.P. 2007). After discharging $215,000 in private student loan debt, the debtors, a married couple, brought a second action to discharge an additional $350,000 in student loans owed to the government, for a stunning total of $565,000 in educational debt. The court allowed a partial discharge, finding it impossible for them to repay their loans in full "unless one or both of the debtors wins the lottery, receives a substantial inheritance, [or] finds a gold mine or a treasure trove in the backyard." 367 B.R. at 130.

created pressure on both judges and lawyers to push the law in new directions to allow relief to overburdened debtors.

This article examines one such solution: the separate classification of student loan debt in chapter 13 plans, an "outside the box" treatment that enables consumer debtors to give preferential treatment to student loan debt. As in chapter 7, student loan debt is generally nondischargeable in chapter 13 cases[4] and does not have priority status.[5] Despite this, debtors may be able to use the provisions of chapter 13 to treat student loan debts more advantageously than other unsecured debts. This is typically accomplished by classifying the student loan claims separately from other unsecured claims, then making the full contract payment directly to the student loan creditor while making a reduced pro rata payment to other unsecured creditors through the plan.[6]

The Conflict Between §§ 1322(b)(1) and (5)

The relevant provisions of the Code for this purpose are §§ 1322(b)(1) and (5).[7] Section 1322(b)(1) allows a chapter 13 plan to "designate a class or classes of unsecured claims, as provided in section 1122 of this title," with the proviso that classification "may not discriminate unfairly" against any class. Section 1322(b)(5) permits a chapter 13 plan to "provide for the

[4] 11 U.S.C. § 1328(a)(2). Student loan debt has been nondischargeable in chapter 13 since 1990. *See In re* Sharp, 415 B.R. 803, 808 (D. Colo. 2009), *citing* the Student Loan Default Prevention Initiative Act of 1990, Pub. L. 101-508, §§ 3001, 3007, 104 Stat. 1388, 1388-28 (1990).

[5] 11 U.S.C. § 507. Because student loan debt does not have priority status, there is no requirement that it be paid in full through the chapter 13 plan pursuant to 11 U.S.C. § 1322(a).

[6] For example, the debtors in *In re* Webb, 370 B.R. 418 (Bankr. N.D. Ga. 2007), proposed to maintain their regular monthly payments to student loan creditors, while making only a 1% payout to other unsecured creditors.

[7] 11 U.S.C. § 1322(b)(10), a provision added by BAPCPA, limits the payment of interest on nondischargeable unsecured claims in chapter 13, and is also a factor in some cases. Section 1322(b)(10) states that a chapter 13 plan may "provide for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are nondischargeable under section 1328(a), except that such interest may be paid only to the extent that the debtor has disposable income available to pay such interest after making provision for *full* payment of all allowed claims . . . ." (Emphasis added.) The leading case dealing with the interplay between §§ 1322(b)(5) and (10) is *In re* Freeman, Case No. 06-10651-WHD, 2006 WL 6589023 (Bankr. N.D. Ga. 2006). *Freeman* concludes that the debtors may ignore § 1322(b)(10) when they propose to cure and maintain student loans under § 1322(b)(5). *See* Cameron M. Fee, *An Attempt at Post-Mortem Revival: Has § 1322(b)(10) Been Euthanized?*, ABI JOURNAL (July 2012) (criticizing the result in *Freeman*).

curing of any default . . . and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due."

Because most student loans are long-term debts with payments extending beyond the life of the plan, they fall within the subset of obligations governed by § 1322(b)(5). Read in isolation, this subsection permits the debtor to maintain contract payments on her student loans, while relegating other unsecured debts to a lower pro rata payment as a separate class. Because this provides preferential treatment to student loan creditors, the issue then becomes whether § 1322(b)(5) controls over the conflicting "unfair discrimination" provision found in § 1322(b)(1).[8]

Decisions Addressing the Conflict

This problem has been discussed by a number of courts, with a minority of reported decisions finding that subsection (b)(5) trumps (b)(1), thereby completely excepting long-term debt payments from the unfair discrimination analysis of subsection (b)(1).[9] Courts that accept this position allow the plan to cure defaults and maintain payments on student loans without regard for the position of other unsecured creditors. Under the majority view, however, subsection (b)(5) must be read in conjunction with (b)(1), with the result that a plan that provides for full payment of student loan obligations under (b)(5) must then be analyzed for unfair discrimination as required by (b)(1).[10]

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[8] The conflicting arguments were nicely summed up by Judge Houston in *In re* Boscaccy: "The trustee's argument is that the debtors' proposals constitute unfair discrimination which is prohibited by 11 U.S.C. § 1322(b)(1). The debtors' position is that, regardless of § 1322(b)(1), they are allowed to separately classify and treat their student loans as proposed pursuant to the "cure and maintain" provision set forth in § 1322(b)(5)." 442 B.R. 501, 505-06 (Bankr. N.D. Miss. 2010).

[9] *In re* Johnson, 446 B.R. 921 (Bankr. E.D. Wisc. 2011); *In re* Truss, 404 B.R. 329, 333 (Bankr. E.D. Wisc. 2009). ("If the plan provides for the cure of a default and maintenance of payments on a debt, the terms of which extend beyond the term of the plan, it is not for the court to determine whether this is fair to the other creditors or not.")

[10] *In re* Zeigafuse, 2012 WL 1155680 (Bankr. W.D. Wyo. 2012); *In re* Pracht, 464 B.R. 486 (Bankr. M.D. Ga. 2012); *In re* Boscaccy, 442 B.R. 501 (Bankr. N.D. Miss. 2010); *In re* Harding, 423 B.R. 568 (Bankr. S.D. Fla. 2010); *In re* Pora, 353 B.R. 247 (Bankr. N.D. Cal. 2006); *In re* Simmons, 288 B.R. 737 (Bankr. N.D. Tex. 2003).

The Code does not define "unfair discrimination," and courts have developed several multi-factor tests to enable this analysis. The most widely used test, the *Wolff* / *Leser* test,[11] has four components: "(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."[12] A variation of the *Wolff* / *Leser* test was adopted in *In re Husted*, which added a fifth factor: an examination of "the difference between what the creditors discriminated against will receive as the plan is proposed, and the amount they would receive if there were no separate classification."[13]

The *Wolff* / *Leser* test has been criticized as offering "no real direction for determining the fairness of discrimination in any given instance,"[14] and other courts have attempted to develop more concrete alternatives.[15] The most prominent of these alternatives is the "baseline" test enunciated by the First Circuit BAP in *In re Bentley*.[16] *Bentley* looks to the "principles and structure of Chapter 13" as the "baseline against which to evaluate discriminatory provisions for unfairness."[17] The decision then enunciates four core principles: (1) absent an express grant of priority, unsecured creditors should share equally, (2) student loan obligations are not priority debts, (3) unless unsecured creditors are paid in full, the chapter 13 debtor must devote all

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[11] This test was adopted by the Eighth Circuit in Mickelson v. Leser (*In re* Leser), 939 F.2d 669 (8th Cir. 1991), and by the Ninth Circuit Bankruptcy Appellate Panel in Amfac Distrib. Corp. v. Wolff (*In re* Wolff), 22 B.R. 510 (9th Cir. BAP 1982).
[12] *In re* Webb, 370 B.R. 418, 423 (Bankr. N.D. Ga. 2007).
[13] 142 B.R. 72, 74 (Bankr. W.D.N.Y. 1992).
[14] Bentley v. Boyajian (*In re* Bentley), 266 B.R. 229 (1st Cir. B.A.P. 2001).
[15] *See*, *e.g.*, *In re* Brown, 152 B.R. 232 (Bankr. N.D. Ill.), *rev'd*, 162 B.R. 506 (N.D. Ill. 1993); *In re* Colfer, 159 B.R. 602 (Bankr. D. Me. 1993). The issue was approached by the Seventh Circuit in *In re* Crawford, 324 F.3d 539, 542 (7th Cir. 2003), which pronounced: "We haven't been able to think of a good test ourselves. We conclude, at least provisionally, that this is one of those areas of the law in which it is not possible to do better than to instruct the first-line decision maker, the bankruptcy judge, to seek a result that is reasonable in light of the purposes of the relevant law, which in this case is Chapter 13 of the Bankruptcy Code."
[16] *Supra* note 14.
[17] *Id*. at 240.

disposable income to the plan, and (4) the facts may indicate that the debtor's interest in a "fresh start" trumps the creditors' claim to a pro rata share.

Regardless of the test that is applied, most courts have concluded that discrimination based on nothing more than nondischargeability is unfair.[18] However, "if the discrimination in question benefits the very creditors who are being discriminated against," for example, by enabling the debtor to work, it may be considered fair.[19] At least one court has also found discrimination justifiable when, absent direct payments, the debtor would emerge from chapter 13 owing more on their student loans than they did before the case was filed.[20] Similarly, separate classification has been allowed when this would allow the debtor to participate in the Public Service Loan Forgiveness program and write off $50,000 of otherwise nondischargeable debt.[21]

The Impact of Projected Disposable Income

BAPCPA added a new wrinkle to this analysis by requiring that the projected disposable income of above-median income chapter 13 debtors be calculated with reference to the "means test" of § 707(b)(2), as opposed to the real numbers reflected on the debtor's schedules I and J. Section 707(b)(2) requires the debtor to use hypothetical amounts specified in National and Local Standards issued by the Internal Revenue Service, creating the possibility that a debtor's projected disposable income under § 707(b)(2) might be less than his actual discretionary income. When this occurs, it is possible for the above-median debtor to devote 100% of his projected disposable income to unsecured creditors in the plan and still retain sufficient excess

[18] Groves v. LaBarge (*In re* Groves), 39 F.3d 212 (8th Cir. 1994); *Pracht*, *supra* note 10; *Boscaccy*, *supra* note 10 at 507 (noting "the general view that discrimination based *solely* on nondischargeability is unfair"); *In re* Gonzalez, 206 B.R. 239 (Bankr. S.D. Fla. 1997).
[19] *In re* Kalfayan, 415 B.R. 907, 910 (Bankr. S.D. Fla. 2009) (debtor's license to practice optometry was contingent on remaining current on her student loans).
[20] *Webb*, *supra* note 12.
[21] *Pracht*, *supra* note 10.

"discretionary" income to make contract payments on his student loans. This strategy has withstood challenge, even when student loans are paid in full and the dividend to other unsecured creditors is extremely low.[22]

Conclusion

On balance, the majority view adopts the best statutory construction by reading subsection (b)(5) in light of (b)(1) and attempting to harmonize the conflict by imposing an unfair discrimination analysis on chapter 13 plans that use § 1322(b)(5) to provide for full payment of student loan debts. The close placement of these provisions, coupled with the specific exclusion of subsection (b)(2) from § 1322(b)(5), are indicators that Congress intended some interplay between (b)(5) and (b)(1) and could have avoided their intersection had it wished to do so.

That said, the statutory language remains confusing at best and challenges bankruptcy judges with an awkward and difficult piece of analysis. Chapter 13 offers a way for debtors to cope with high levels of student loan debt, and Congress could enable this solution by clarifying the chapter 13 plan provisions that apply when debtors separately classify student loan obligations and provide preferential treatment for them.

[22] *In re* Abaunza, 452 B.R. 866 (Bankr. S.D. Fla. 2011) (plan did not unfairly discriminate when projected disposable income resulted in dividend of only 0.86%); *In re* King, 460 B.R. 708 (Bankr. N.D. Tex. 2011); *In re* Sharp, 415 B.R. 803 (Bankr. D. Colo. 2009); *In re* Orawsky, 387 B.R. 128 (Bankr. E.D. Penn. 2008).