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Bankruptcy-Prior Discharge Within Six Years as Bar to Wage Earner's Extension Plan

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RECENT DECISIONS

BANKRUPTCY—PRIOR DISCHARGE WITHIN SIX YEARS AS BAR TO WAGE EARNER'S EXTENSION PLAN—Appellant, a debtor, sought confirmation of a wage earners' extension plan pursuant to Chapter XIII of the Bankruptcy Act.[1] Section 656 prohibits confirmation of a plan under Chapter XIII if the debtor would have been denied an ordinary discharge in bankruptcy had he been seeking one.[2] A discharge within six years prior to the date of filing constitutes a bar to such discharge.[3] The referee, finding that the debtor had obtained a discharge within six years, dismissed the proceedings. On appeal from the district court's affirmance, *held*, affirmed. Since a wage earner's extension plan clearly contemplates a discharge of debts, confirmation is barred under sections 656a and 14c(5) by a prior discharge within six years. *In re Schlageter*, 319 F.2d 821 (3d Cir. 1963).

Wage earner plans, first provided for in the Chandler Act of 1938,[4] differ from ordinary bankruptcy proceedings in that their aim is not liquidation of the debtor's estate, but application of future earnings to pay his debts.[5] To commence a Chapter XIII proceeding the wage earner[6] must file a petition alleging that he is insolvent or unable to pay his debts as they mature, and that he desires to effect a composition or extension, or both, out of his future earnings.[7] An extension contemplates payment in full over an extended period of time, whereas a composition undertakes

1 Sections 601-86, 52 Stat. 930 (1938), as amended, 11 U.S.C. §§ 1001-86 (1958 & Supp. IV, 1963). See generally 10 COLLIER, BANKRUPTCY 531-742 (14th ed. 1962 & Supp. 1962).

2 Section 656a provides: "The court shall confirm a plan if satisfied that . . . (3) the debtor has not been guilty of any of the acts or failed to perform any of the duties which would be a bar to the discharge of the bankrupt. . . ." 52 Stat. 935 (1938), as amended, 11 U.S.C. § 1056(a) (1958).

3 Section 14c provides: "The court shall grant the discharge unless satisfied that the bankrupt . . . (5) in a proceeding under this Act commenced within six years prior to the date of the filing of the petition in bankruptcy had been granted a discharge, or had a composition or an arrangement by way of composition or a wage earner's plan by way of composition confirmed under this Act. . . ." 52 Stat. 850 (1938), as amended, 11 U.S.C. § 32(c) (Supp. IV, 1963).

4 Chandler Act, ch. 575, 52 Stat. 883 (1938).

5 The virtues of Chapter XIII wage earner plans have been extolled, from both a moral and economic standpoint, in several legal publications. See generally Abramson, *A Comment on Habitual Proceedings*, 37 REF. J. 94 (1963); Nadler, *An Aid to Public Relations: Help the Wage Earner Make Good—(Under Chapter XIII)*, 64 COM. L.J. 38 (1959); Riley, *Chapter XIIIs in the Madison Bankruptcy Court*, 37 REF. J. 55 (1963). However, for a vigorous argument against over-emphasizing wage earner plans, see Walker, *Is Chapter XIII a Milestone on the Path to the Welfare State?*, 33 REF. J. 7 (1959). *But see* Allgood, *Chapter XIII—Referee Allgood of Alabama Replies to Referee Walker*, 33 REF. J. 51 (1959).

6 Section 606 provides: ". . . (8) 'wage earner' shall mean an individual whose principal income is derived from wages, salary or commissions." 64 Stat. 1134 (1950), as amended, 11 U.S.C. § 1006 (Supp. IV, 1963).

7 Section 623, 52 Stat. 932 (1938), 11 U.S.C. § 1023 (1958). As a debtor need only be "unable to pay his debts as they mature" he may be able to get a wage earner's extension plan although he has sufficient non-exempt assets to allow his creditors to recover their claims. See 15 STAN. L. REV. 518, 521-22 (1963).

only partial payment. Upon notice to all creditors the court calls a meeting,[8] at which the debtor submits his plan, if it has not earlier been filed.[9] To be confirmed, the plan must be approved by all secured creditors as well as a majority of unsecured creditors; it must also meet the requirements of section 656.[10] The plan need not satisfy section 656 if approved by all creditors, both secured and unsecured.[11] If confirmed, the plan is binding on both debtor and creditor,[12] and if the debtor completes the plan and payments thereunder the court will discharge him.[13] He may also be discharged after three years, although not having completed the payments, if his failure was due to circumstances for which he could not be held accountable.[14]

Section 656a(3) prohibits confirmation of a plan under Chapter XIII if the debtor is guilty of any act that would constitute a bar to discharge in a straight bankruptcy proceeding. A prior discharge within six years is such an act.[15] The word "plan" is defined in section 606(7)[16] to include a composition, extension, or both, and there is a further reference to this definition in section 623.[17] A literal reading of the statute must therefore result in a finding that confirmation of an extension plan will be denied if the debtor has received a prior discharge in bankruptcy within six years. It is settled that a prior discharge within six years bars the confirmation of a Chapter XIII composition.[18] The question is whether sections 14c(5) and 656a(3), in combination, similarly preclude the confirmation of an extension plan—in other words, whether or not the statute should be read literally.

The view that an extension is not barred by a prior discharge in bankruptcy within six years has been taken by two federal district courts in

8 Sections 632-33(2), 52 Stat. 932 (1938), 11 U.S.C. §§ 1032-33(2) (1958).

9 The plan must meet the requirements of § 646, 52 Stat. 934 (1938), 11 U.S.C. § 1046 (1958). The plan "may," but need not, deal with secured creditors.

10 Section 652, 52 Stat. 934 (1938), 11 U.S.C. § 1052 (1958). A "majority" of unsecured creditors means a majority both of the number of creditors and of the amount of claims allowed.

11 Section 651, 52 Stat. 935 (1938), 11 U.S.C. § 1051 (1958).

12 Section 657, 52 Stat. 934 (1938), 11 U.S.C. § 1057 (1958).

13 Section 660, 66 Stat. 437 (1952), 11 U.S.C. § 1060 (1958).

14 Section 661, 66 Stat. 437 (1952), 11 U.S.C. § 1061 (1958). Because of this section many courts require that a Chapter XIII plan be capable of completion within three years, although there is no statutory limit on the length of time a plan may run. See NADLER, BANKRUPTCY 836 (1948).

15 A discharge, on its face, is not an act of guilt on the part of the debtor. See *In re* Goldberg, 53 F.2d 454 (6th Cir. 1931).

16 Section 606(7), 64 Stat. 1134 (1950), 11 U.S.C. § 1006(7) (Supp. IV, 1963).

17 Section 623, 52 Stat. 932 (1938), 11 U.S.C. § 1023 (1958).

18 Section 14c(5) specifically lists confirmation of a Chapter XIII composition plan as a bar to subsequent discharge within six years, and a discharge would bar confirmation of a subsequent composition within the six-year period. *In re* Kornbluth, 65 F.2d 400 (2d Cir. 1933); *cf. In re* Jenson, 200 F.2d 58 (7th Cir. 1952), *cert. denied*, 345 U.S. 926 (1953) (alternative holding) (Chapter XI extension barred by prior discharge in bankruptcy).

In re Mahaley[19] and *In re Sharp*.[20] Compositions and extensions were there distinguished on the ground that the latter are not discharges since they contemplate repayment of debts in full; however, compositions resemble discharges in that they involve a reduction of debts.[21] Finding the purpose of section 14c(5)—prevention of the development of a class of habitual users of the Bankruptcy Act[22]—to be generally inconsistent with the purpose of Chapter XIII, which is to encourage extension plans,[23] these courts turned to section 602,[24] which states that the provisions of Chapters I through VII (which include section 14c(5)) do not apply if they are inconsistent with the provisions of Chapter XIII. Having already distinguished extensions and compositions, they were able to hold that section 14c(5) does not apply to the confirmation of Chapter XIII extension plans without having to say the same of compositions, which are clearly subject to the six-year rule. The *Mahaley-Sharp* line of reasoning, therefore, avoids the result of a literal interpretation of the statute by, in effect, reading a proviso into section 656a(3) that section 14c(5) shall not preclude the confirmation of an extension plan.

The principal case, which is the first federal court of appeals decision holding that an extension plan is barred by a prior discharge within six years,[25] rejected the *Mahaley-Sharp* distinction between extension plans and compositions. The court held that a discharge is clearly contemplated by the statute in both types of plans; it therefore saw no reason to exempt extensions from the six-year rule. The same conclusion was reached by a federal district court in *In re Bingham*,[26] where the court cited strong

19 187 F. Supp. 229 (S.D. Cal. 1960).

20 205 F. Supp. 786 (W.D. Mo. 1962).

21 This distinction has been accepted by Congress. Prior to 1938 there was a split among the courts as to whether compositions were subject to the six-year rule. *In re* Kornbluth, 65 F.2d 400 (2d Cir. 1933) (prior composition held to bar a discharge). *Contra*, *In re* Goldberg, 53 F.2d 454 (6th Cir. 1931) (prior composition does not bar a composition). In 1938 § 14c(5) was changed to include compositions as a cause of bar. In pointing out that there was no need to include prior extensions in section 14c(5), H.R. REP. No. 1409, 75th Cong., 1st Sess. 29 (1937), states that, as a composition under Chapter XIII acts as a discharge, there is no reason not to treat it as such, but that an extension differs from a composition in that it operates to pay debts in full. See also *In re* Holmes, 309 F.2d 748 (10th Cir. 1962); *In re* Mahaley, 187 F. Supp. 229 (S.D. Cal. 1960); *In re* Verlin, 148 F. Supp. 660 (E.D.N.Y. 1957), *aff'd sub nom.* Fishman v. Verlin, 255 F.2d 682 (2d Cir. 1958); *In re* Thompson, 51 F. Supp. 12 (W.D. Va. 1943). *But see* 15 STAN. L. REV. 518, 520-21 (1963), for an argument that the distinction between extensions and compositions, though well documented, is unrealistic because under either plan a debtor may reduce his obligations to a certain extent.

22 See *In re* Sharp, 205 F. Supp. 786, 788 (W.D. Mo. 1962).

23 *Id.* at 787.

24 52 Stat. 930 (1938), 11 U.S.C. § 1002 (1958).

25 Edins v. Helzberg's Diamond Shops, Inc., 315 F.2d 223 (10th Cir. 1963), followed the *Mahaley-Sharp* view in a brief per curiam opinion.

26 190 F. Supp. 219 (D. Kan. 1960), *appeal dismissed sub nom.* Bingham v. Yingling Chevrolet Co., 297 F.2d 341 (10th Cir. 1961). In this case the debtor applied for confirmation of an extension plan, having received a prior confirmation of a Chapter XIII plan within six years. The court was unclear as to whether the prior Chapter XIII plan was by way of composition or extension. *In re* Holmes, 309 F.2d 748 (10th Cir. 1962), which in-

policy reasons in favor of this result, namely, loss of interest to the creditors for the duration of the plan and the danger that a secured creditor might lose his security.[27] The *Bingham-Schlageter* position is not without merit. It may be undesirable in some circumstances to confirm as a matter of course an extension plan within six years after a prior discharge.[28] The most common problem in allowing frequent extension plans is that the debtor will allow himself to become perennially over-committed, the result being the creation of a class of debtors habitually under the protection of the Bankruptcy Act.[29]

Considering all the arguments, however, the *Mahaley-Sharp* position seems to achieve a sounder result.[30] Although those courts disregarded the literal terms of the statute, their conclusion that extension plans should be exempted from the six-year rule is so strongly supported by policy considerations as to justify the vague reasoning employed. In the majority of cases, confirmation of an extension plan is desirable from both the debtors' and the creditors' point of view. The debtor is free from the harassment of garnishment and attachment by creditors while he attempts to repay his debts in full. It has been said that by utilizing an extension plan the cost of relief to the debtor is lowered, and he receives an education in budgeting as well.[31] Moreover, confirmation of such a plan is desirable from a creditor's

volved two consecutive extension plans, purported to overrule the *Bingham* case, stating that the two cases involved "similar facts." See 47 IOWA L. REV. 155 (1961), for a conclusion that the prior plan in the *Bingham* case was by way of composition. This seems to be the better explanation of the case.

The argument that a creditor may stand to lose his security must at least be qualified by the fact that no plan can be confirmed under Chapter XIII without the acceptance of all secured creditors whose claims are covered by the plan. See Kennedy, *Hospitality for Repeaters Under the Bankruptcy Act*, 68 COM. L.J. 117, 123 & n.41 (1963).

27 *In re* Bingham, 190 F. Supp. 219, 221 (D. Kan. 1960), *appeal dismissed sub nom.* Bingham v. Yingling Chevrolet Co., 297 F.2d 341 (10th Cir. 1961).

28 There is a danger that the debtor may use the Chapter XIII extension plan as a merely temporary measure to hold off unsecured creditors while the secured creditors collect, then drop the proceeding or convert it into straight bankruptcy after having paid off on property which will be exempted. See Walker, *supra* note 5, at 8. He may also plan to get a release later under § 661, 66 Stat. 437 (1952), 11 U.S.C. § 1061 (1958), without having completed the plan.

29 See Walker, *supra* note 5; Wiese, *Bankruptcy Discharge Does Not Prohibit Chapter XIII Proceeding*, 15 PERSONAL FINANCE L.Q. REPORT 22 (1960); 15 STAN. L. REV. 518 (1963).

30 Most writers seem to agree that wage earner extension plans should be freely available, notwithstanding prior discharges. See Abramson, *supra* note 5; Nadler, *supra* note 5; Riley, *supra* note 5. It has been uniformly held that successive Chapter XIII extension plans are not subject to the six-year rule. *In re* Holmes, 309 F.2d 748 (10th Cir. 1962); *In re* Autry, 204 F. Supp. 820 (D. Kan. 1962).

31 Riley, *supra* note 5. See Kennedy, *Debt Pooling Arrangements vs. Chapter XIII Proceedings*, 46 ILL. B.J. 816 (1958), reprinted in 32 REF. J. 109 (1958), for a conclusion that, in an average case, the costs to the debtor of a Chapter XIII plan, are about equal to those of private debt pooling; however, in the former case the fees include competent legal aid to the debtor, while in the latter they do not. See also Maulitz, *Operations Under Chapter XIII*, 27 REF. J. 68 (1953), for examples of how wage earner plans in Alabama have been made more economical.

point of view in most cases.[32] Illustratively, a man's creditors stand to gain very little if the debtor loses his job as a result of garnishment. Nor is the loss of interest to creditors nearly so severe as is the case when a debtor receives an ordinary discharge in bankruptcy.[33]

The trend in recent years has been toward a wider use of extension plans,[34] especially since the wage limit on eligibility for Chapter XIII plans was removed in 1959. The question of the six-year rule, therefore, becomes more significant in the face of the need for a rule that will insure maximum availability of Chapter XIII extension plans to the wage earner. In recognition of this need, the National Bankruptcy Conference has approved amendments to sections 14c(5)[35] and 656a(3)[36] which would, in effect, codify the *Mahaley-Sharp* view.[37]

If, however, extension plans are to be made freely available to wage earners, the courts must remain alert to possible abuses. Perhaps the best safeguard is found in section 656,[38] which provides that a plan cannot be confirmed unless it is submitted in good faith and in the best interests of the creditors.[39] Another safeguard consists of the creditors themselves, as no Chapter XIII plan may be confirmed without the consent of all the secured creditors and a majority of the unsecured creditors whose claims are covered by the plan.[40] When courts discover after confirmation that debtors have entered upon extension plans intending to use them merely as a means to hold their creditors at bay,[41] these plans could be dismissed pursuant to

32 See generally Allgood, *supra* note 5; Riley, *supra* note 5.

33 Under Chapter XIII plans creditors collect a far greater proportion of what is owed them than in straight bankruptcy proceedings. In 1962 asset bankruptcy cases (in which creditors collect far more than in non-asset or nominal asset cases), the total payments to creditors were only $52,404,479 out of $274,834,940 total indebtedness, or 19.1%. Comparatively, in Chapter XIII proceedings $6,344,660 was paid to creditors holding $6,555,129 in claims allowed—about 97% satisfaction. ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, TABLES OF BANKRUPTCY STATISTICS FOR PERIOD ENDING JUNE 30, 1962.

34 Decreases were reported in all types of bankruptcy proceedings in 1962 except those filed under Chapter XII (real estate arrangements) and Chapter XIII. Chapter XII proceedings increased 19.3%, but only from 31 to 37 cases. Chapter XIII proceedings showed an increase from 19,723 to 22,880 cases, an increment of 16.0%. Comparatively, there was an increase of only 1137 cases, or 0.8% in all other types of bankruptcy proceedings. ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS, *op. cit. supra* note 33, at 7.

35 See Proceedings of Nat'l Bankruptcy Conf. Ann. Meeting, Oct. 25-26, 1962, p. 11, cited in Kennedy, *supra* note 26, at 124. The amendment excepts discharges on completion of extension plans under § 660, 66 Stat. 437 (1952), 11 U.S.C. § 1060 (1958), from the six-year rule. The implication is that a discharge on completion of a composition under § 660, and any discharge under § 661, 66 Stat. 437 (1952), 11 U.S.C. § 1061 (1958), would be treated as a regular discharge, subject to the six-year rule. See Kennedy, *supra* note 26.

36 Summary of Proceedings of Nat'l Bankruptcy Conf. 1961 Ann. Meeting, Res. No. 2, cited in Kennedy, *supra* note 26, at 124.

37 Kennedy, *supra* note 26, at 124.

38 Sections 656a(2), (4), 66 Stat. 437 (1952), 11 U.S.C. §§ 1056(a)(2), (4) (1958).

39 Compare 15 STAN. L. REV. 518, 523 (1963), for a speculation that *In re Sharp* may create a norm of confirming Chapter XIII extension plans without regard to prior discharges, compositions, or extensions.

40 Section 652, 52 Stat. 934 (1938), 11 U.S.C. § 1052 (1958).

41 See text accompanying note 28 *supra*. It has been suggested that the courts should

section 671.[42] Perhaps the greatest fear among those who oppose the exemption of extension plans from the six-year rule is that this will expand the class of perennially over-committed wage earners who are constantly under the protection of the courts. Such a possibility may be mitigated by setting a statutory limit on the number of extension plans available to the debtor. The court may also find a plan submitted by a debtor who has filed for relief an extensive number of times not to be in the best interests of the creditors. Despite some risk of abuse, these safeguards would appear sufficiently reliable to justify adherence to the policy of making extension plans available without the burdening limitation of the six-year rule.

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treat a plan calling for the rejection of the debtor's executory contracts (pursuant to §§ 642, 646(6), 52 Stat. 933, 934 (1938), 11 U.S.C. §§ 1042, 1046(6) (1958) as a composition and therefore subject to the six-year rule. See 15 STAN. L. REV. 518 (1963). It is claimed that such a procedure would make the distinction between extensions and compositions more realistic because an extension plan which calls for the rejection of executory contracts tends to reduce the debtor's total obligations. This rationale for distinguishing this type of extension plan is not convincing. Pursuant to § 642, the debtor will have to pay reasonable damages to those whose contracts are rejected, and therefore the party whose executory contract is rejected is compensated for any loss he may sustain.

42 Section 671 provides that a plan may be dismissed for fraud in its procurement. 52 Stat. 937 (1938), 11 U.S.C. § 1071 (1958). Perhaps the construction of the word "fraud" could be expanded to reach debtors who do not intend to complete their extension plans.