Separate Classification of Student Loan Debt

John Rao
National Consumer Law Center, Inc.

Overview of Separate Classification

Most payments made by consumer debtors in Chapter 13 cases are paid to secured creditors such as home mortgage and car loan lenders. Unsecured creditors, which would include student loan lenders, receive a pro rata share of the funds distributed under the plan for those unsecured creditors. Depending upon the amount of the debtor’s nonexempt property and income left over after paying necessary living expenses, a consumer’s plan may pay unsecured creditors at less than one-hundred percent of what they are owed, in some cases as low as zero to ten percent, without interest.

Absent a finding of undue hardship under section 523(a)(8), debtors remain obligated to pay upon completion of their Chapter 13 plan the amount owed on student loan debt that has not been paid under the plan. This includes any unpaid interest on the debt that has accrued during the plan. Thus, it is often in the debtor’s interest to pay off as much of the student loan debt in the Chapter 13 plan as is permissible.

For consumers who are current on their student loans at the time they file a Chapter 13 case, and wish to remain current, requiring them to pay their student loans pro rata with other unsecured claims almost always has the effect of forcing these consumers to default on such loans. This is because they would not be permitted to maintain the regular installment payment, which includes interest. It also causes other serious problems for debtors, such as loss of current status for the Department of Education’s income driven repayment plans and loan forgiveness programs. Requiring nondischargeable student loans to be paid with other unsecured debts undermines the public policy of encouraging consumers to pay back the government debt, which is often stated as a reason why Congress made student loans nondischargeable.

One way to pay more on student loans than on other unsecured debts is to separately classify the student loans for payments at a higher percentage than other unsecured debts pursuant to 11 U.S.C. § 1322(b)(1). This section states, “... the [chapter 13] plan may . . . designate a class or classes of unsecured claims . . ., but may not discriminate unfairly against any class so designated.” Recent cases have been divided, both in the means of analysis and the result, as to whether students can separately classify student loans. Debtors are permitted to discriminate among similar classes of creditors in a plan. The issue is whether a separate classification for one creditor discriminates unfairly against other creditors within the same class.

Variety of Multi-Part Tests

The courts have developed a number of tests that purport to determine whether a

---

1 If the student loan debt is nondischargeable, postpetition interest will not be discharged. See In re Kielisch, 258 F.3d 315 (4th Cir. 2001); In re Pardee, 218 B.R. 916 (B.A.P. 9th Cir. 1998), aff’d, 187 F.3d 648 (9th Cir. 1999); In re Jordan, 146 B.R. 31 (D. Colo. 1992).
discriminatory classification that favors one creditor is fair. These tend to be multi-factor tests that allow the courts considerable discretion. The test developed by the Eighth Circuit in *In re Leser*\(^2\) has been applied by many courts. This four-part test considers whether:

(1) the discrimination has a rational basis;
(2) classification is necessary to debtor’s rehabilitation under chapter 13;
(3) the discrimination is proposed in good faith; and
(4) there is meaningful payment to class discriminated against.

Noting that the *Leser* test has been criticized for “numerous shortcomings,” the First Circuit B.A.P. in *In re Bentley*\(^3\) adopted a test that considers whether:

(1) unsecured creditors shared equally in any dividend;
(2) subject debts were priority debts;
(3) debtors devoted the minimum or more than minimum to their plan;
(4) unsecured creditors shared in mandatory contribution on a pro rata basis; and
(5) debtor’s interest in a “fresh start” trumped creditors’ claim to a pro rata sharing.

While not rejecting a five-part test that had previously been used, one court recently concluded that one of the factors, the difference between what the creditors discriminated against will receive under the plan versus the amount they would receive if there was no separate classification, has been “unduly emphasized in prior cases.”\(^4\) The court found that while this factor may be considered, it should not be controlling. The court therefore adopted a “streamlined test” that considers:

(1) is there a good faith, rational basis for the separate classification;
(2) is the separate classification necessary to the debtor's rehabilitation under Chapter 13; and
(3) is there a meaningful payment to the discriminated class.\(^5\)

Another court recently noted that there are at least nine different tests used, which the court described as follows: Strict Approach, Flexible Approach, Balance Approach, Reasonableness Approach, Bright Line Approach, Percentage of Repayment Approach, Interest of Debtor Approach, Multifactor Approach and the Bentley Baseline Test.\(^6\) The court ultimately concluded that “none of the tests should stand as a rigid barrier to confirmation of the Debtors Plan.”\(^7\) After reviewing many of the multi-pronged tests, one court of appeals rejected them in favor of a recommendation that courts simply use their best judgment on a case-by-case basis

\(^2\) 939 F.3d 669 (8th Cir. 1991).
\(^3\) 266 B.R. 229 (B.A.P. 1st Cir. 2001). See also *In re Salazar*, 543 B.R. 669 (Bankr. D.Kan. 2015) (adopting the Bentley test for determining whether a plan discriminates unfairly).
\(^5\) *Id.* at *7*.
\(^7\) *Id.* at 538.
when reviewing unfair discrimination claims in chapter 13. Ultimately many courts view the totality of circumstances in making the fairness determination.

Application the Fairness Requirement in Section 1322(b)(1)

Courts have found that the following arguments support the debtor’s separate classification of student loan debt:

- Debtor would lose discharge under Public Loan Forgiveness program and discrimination advances the public policy objective of paying off student loan debts;

- Discrimination is not unfair when there is no harm to the unsecured creditors;

- There is a reasonable basis for the discrimination and/or a less discriminatory approach would leave the debtor or creditors worse off;

---

8 In re Crawford, 324 F.3d 539 (7th Cir. 2003); see also In re Osorio, 522 B.R. 70, 77 (Bankr. D. N.J. 2014) (the competing unfair discrimination tests come down to case-by-case evaluations in which no single factor controls); In re Knowles, 501 B.R. 409, 415 (Bankr. D. Kan. 2013) (courts have “wide discretion” in determining whether proposed discrimination in favor of student loan creditor is unfair).

9 In re Pracht, 464 B.R. 486 (Bankr. M.D. Ga. 2012) (separate classification and higher payment rate for student loan debt not unfairly discriminate because it allowed debtor to participate in the Public Loan Forgiveness program and gave her the chance to write off approximately $50,000 of student loan debt; such discrimination advanced the goal of a fresh start for the debtor and the public policy objective of payment of student loan debts; cost of this discrimination to unsecured creditors was 5%, or a total of only $5,000).

10 In re Potgieter, 436 B.R. 739 (Bankr. M.D. Fla. 2010) (chapter 13 plan that separately classified student loan obligation and proposed to pay it at the contract rate outside of the plan did not unfairly discriminate because the plan provided for full repayment of all general unsecured claims; the student loan obligation was non-dischargeable such that the debt would be fully repaid at some point; and the debtor had the right, under § 1322(b)(4), “to provide for payments on any unsecured claim to be made concurrently with payments on any secured claim”).

11 In re Belton, 2016 WL 7011570, at *7 (Bankr. D.S.C. Oct. 13, 2016) (“Debtor testified that she cannot obtain either a state or federal job as a paralegal or administrative assistant while her student loans are in default because as a paralegal, this default status is perceived by employers to impact her reliability in the handling of funds”); In re Mason, 456 B.R. 245 (Bankr. N.D. W. Va. 2011) (separate classification to allow student loan creditor to receive a higher percentage payment than other unsecured creditors may be allowed if the debtor can articulate a non-arbitrary reason why the discrimination is necessary and demonstrate that a less discriminatory approach is not advisable); In re Boscaccy, 442 B.R. 501 (Bankr. N.D. Miss. 2010) (separate classification for long-term student loan debt to allow for cure and maintenance not unfairly discriminatory when such classification reduced payments to other unsecured creditors by 21% and 26% because failure to maintain payments on student loan debts would leave debtors in a much worse position than they were in prior to filing); In re Kalfayan, 415 B.R. 907 (Bankr. S.D.
Payment of student loans, ahead of other unsecured debt, is not unfair discrimination;\(^{12}\)

Funds used are in excess of projected disposable income;\(^{13}\)

Discrimination is not unfair so long as unsecured creditors receive at least as much as they would in a Chapter 7 proceeding.\(^{14}\)

\(^{12}\) In re Foreman, 136 B.R. 532 (Bankr. S.D. Iowa 1992) (debtor’s plan, which proposed concurrent payment of student loans and a secured claim, to be followed by full payment of the remaining unsecured claims did not unfairly discriminate under the test set forth in Matter of Tucker because the plan provided for full repayment of all unsecured claims; the student loan obligations were non-dischargeable; and the debtor had a right to under § 1322(b)(4) to propose this repayment structure).

\(^{13}\) In re Kindle, 580 B.R. 443, 451 (Bankr. D.S.C. 2017) (“Debtors are voluntarily contributing their discretionary income (the difference between their means test disposable income and their Schedule J disposable income) to increase the amount paid to those creditors.”); In re Stull, 2013 WL 1279069 (Bankr. D. Kan. Mar. 27, 2013) (above-median debtor’s chapter 13 plan to separately classify and pay a non-dischargeable obligation from income earned in excess of the projected disposable income committed to pay unsecured debt does not unfairly discriminate; plan in this case ultimately rejected because it proposed to pay interest on the student loan, which is prohibited by § 1322(b)(10) absent provision to pay all allowed claims in full).

\(^{14}\) In re Kindle, 580 B.R. 443, 451 (Bankr. D.S.C. 2017) (“Interest on Debtors' student loans equals nearly $200.00 per month. If Debtors are not allowed to continue making regular payments on their student loans, interest will continue to accrue at this significant rate.”); In re Tucker, 159 B.R. 325 (Bankr. D. Mont. 1993) (plan that proposed to pay nondischargeable student loan debt in full while only paying 29% dividend to other unsecured creditors did not unfairly discriminate because creditors would otherwise receive little or no payment under a chapter 7 filing); In re Boggan, 125 B.R. 533 (Bankr. N.D. Ill. 1991) (“chapter 13 plan may provide for a greater percentage payment to an educational lender than to other unsecured creditors, but not by reducing the payments to those other creditors to a level below what they

(continue from previous text)
The following arguments support the view that separate classification of student loan debt is not permitted:

- Nondischargeability, by itself, does not justify discrimination;\(^{15}\)
- Student loans co-signed by parents for children do not fall into the consumer debt exception and thus must meet the unfair discrimination requirement;\(^{16}\)
- Fresh start and/or public policy in favor payment of student loans is not reasonable justification for discrimination;\(^{17}\)
- Avoiding harm to the debtor is not a reasonable basis for discrimination;\(^{18}\)

would get in a Chapter 7 liquidation of the debtor's assets”; plan that proposed to pay student loan debts in full but only 15% of other unsecured debts approved).\(^{15}\) In re Groves, 39 F.3d 212 (8th Cir. 1994) (nondischargeability of student loans does not, by itself, justify “substantial” discrimination against general unsecured debt; additionally, a debtor’s interest in a fresh start does not justify separately classifying student loans for the sole purpose of paying those debts in a manner that prejudices other unsecured claims); In re Sperna, 173 B.R. 654 (B.A.P. 9th Cir. 1994) (nondischargeability, on its own, is not a reasonable basis for preferential treatment of student loans and does not demonstrate that such discrimination is necessary; at issue were two chapter 13 plans that proposed to pay student loans in full while paying other unsecured debt lesser amounts, i.e. 1.4% and 12.21%); McCullough v. Brown, 162 B.R. 506 (N.D. Ill. 1993)(chapter 13 plans that proposed to pay nondischargeable student loans in full and other unsecured claims between 10% and 20% could not be confirmed on the basis of nondischargeability; court holds that for a plan to pass the unfair discrimination test “debtor must place something material onto the scales to show a correlative benefit to the other unsecured creditors”).\(^{16}\) In re Santana, 480 B.R. 222 (Bankr. D.P.R. 2012) (limiting the application of the § 1322(b)(1) consumer debt exception to co-signed debt acquired for the benefit of the debtor rather than a co-signer, court holds that a student loan co-signed by debtor father for his son did not fall within the exception because students loans generally benefit the co-signer and not the debtor).\(^{17}\) In re Birts, 2012 WL 3150384 at 4 (E.D. Va. Aug. 1, 2012) (debtor’s status as a single mother with three children, her generic interest in a “fresh start” and a strong public policy in favor of the federal student loan program were insufficient to justify discrimination in favor of the nondischargeable student loan debt); In re Bentley, 266 B.R. 229 (B.A.P. 1st Cir. 2001) (chapter 13 plan to pay debtors’ student loan debt in full but a 3.6% dividend to other unsecured creditors was unfair discrimination; debtors’ interest in a fresh start did not justify discrimination in a plan that proposed to pay only the minimum required into the plan, i.e. projected disposable income over three years).\(^{18}\) In re Kubeczko, 2012 WL 2685115 (Bankr. D. Colo. July 6, 2012) (fact that separate classification and payment of the student loan would have prevented debtor’s default on student loans and the accrual of substantial interest was not enough to justify the discrimination); In re Knecht, 410 B.R. 650 (Bankr. D. Mont. 2009) (debtor’s sole basis for the discrimination was not knowing if he would live or work long enough to repay his student loan debt because of health
Discrimination is unfair in the absence of proof that it is necessary or reasonable.\textsuperscript{19}

Curing and Maintaining Long-Term Student Loan Debt

Another way to pay more on the student loan than on other unsecured debts is to provide in the plan that the debtor will maintain direct ongoing monthly payments to a student loan creditor under section 1322(b)(5). This section permits the chapter 13 debtor to “cure a default and maintain payments on long term debts on which the final payment is due after the final payment of the plan.” A number of courts have permitted chapter 13 debtors to direct ongoing monthly payments to a student loan creditor under section 1322(b)(5).\textsuperscript{20}

However, many courts refuse to give effect to section 1322(b)(5) as a distinct Code provision and have required debtors proposing to pay ongoing student loan payments directly from current income to satisfy the unfair discrimination test under section 1322(b)(1).\textsuperscript{21} If the

\begin{itemize}
  \item issues but he failed to link his health issues to his life span or his ability to earn a respectable wage after completion of the plan).
\end{itemize}

\textsuperscript{19} In re Thibodeau, 248 B.R. 699 (Bankr. D. Mass. 2000) (debtor failed, under Leser test, to demonstrate that plan to separately classify and fully pay student loan arrearages, maintain student loan payments outside of plan and pay a 27% dividend on other general unsecured claims, while devoting less than the full amount of debtor’s net disposable income to payments under the plan, did not unfairly discriminate); In re Gonzalez, 206 B.R. 239 (Bankr. S.D. Fla. 1997) (chapter 13 plan that proposed to pay student loan debt in full and a 6% dividend to unsecured creditors could not be confirmed because debtor’s offered no proof of the discrimination being “fair” or “necessary”); In re Renteria, 2012 WL 1439104 (Bankr. D. Colo. Apr. 26, 2012) (below median income debtors’ chapter 13 plan to separately classify student loans to allow for 64% repayment of those claims over 60 month period versus a 1% repayment of all other unsecured claims constituted unfair discrimination).

\textsuperscript{20} In re Johnson, 446 B.R. 921 (Bankr. E.D. Wis. 2011); In re Machado, 378 B.R. 14, 17 (Bankr. D. Mass. 2007) (in providing for cure and maintenance of payments, chapter 13 plan can allow for current payments to be paid by debtor directly to creditor, while only payments to cure prebankruptcy arrearage need be paid through trustee and subject to trustee’s commission); In re Webb, 370 B.R. 418 (Bankr. N.D. Ga. 2007) (debtor may pay general unsecured creditors a 1% dividend through plan payments while making regularly scheduled student loan payments directly to student loan creditor pursuant to 11 U.S.C. § 1322(b)(5)); In re Knight, 370 B.R. 429 (Bankr. N.D. Ga. 2007); In re Williams, 253 B.R. 220, 227–28 (Bankr. W.D. Tenn. 2000); In re Chandler, 210 B.R. 898 (Bankr. D.N.H. 1997); In re Sullivan, 195 B.R. 649, 658 (Bankr. W.D. Tex. 1996); In re Cox, 186 B.R. 744, 746–47 (Bankr. N.D. Fla. 1995); In re Benner, 156 B.R. 631, 634 (Bankr. D. Minn. 1993) (using cure and maintain provisions of § 1322(b)(5) is a form of separate classification that meets the fairness standard of § 1322(b)(1)); In re Christophe, 151 B.R. 475 (Bankr. N.D. Ill. 1993); In re Saulter, 133 B.R. 148 (Bankr. W.D. Mo. 1991).

\textsuperscript{21} In re Jordahl, 539 B.R. 567 (B.A.P. 8th Cir. 2015); In re Labib-Kiyarash, 271 B.R. 189 (B.A.P. 9th Cir. 2001) (use of section 1322(b)(5) is subject to debtor showing that classification is fair under section 1322(b)(1)); In re Boscaacy, 442 B.R. 501 (Bankr. D. Miss. 2010); In re
court does not find that this separate classification will fairly discriminate and therefore requires the debtor to make pro-rata distributions rather than ongoing contractual payments to student loan creditors, a debtor who is current on student loan payments when the bankruptcy is filed will be thrown into default. This undermines the goal of paying back the government debt to help the federal treasury (which was one of the other purposes of the nondischargeability provision and its extension). It also causes various other consequences to the debtor, such as loss of current status for administrative repayment and loan forgiveness programs.  

Can the Debtor Pay Interest Due on Student Loans?

Another obstacle in using section 1322(b)(5) to maintain ongoing student loan payments during the plan is a provision added to the Code by the 2005 amendments. Section 1322(b)(10) states that if a chapter 13 plan provides for the payment of ongoing postpetition interest on a nondischargeable debt, the 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.” In other words, the debtor would have to propose to pay all unsecured creditors’ claims in full during the chapter 13 case if the debtor wanted to continue making student loan payments that include interest. Some courts have accepted this broad view of section 1322(b)(10). Other courts take the view that section 1322(b)(5) is a specific provision that can be read consistently with the more general language of section 1322(b)(10), thereby permitting the contractual maintenance payments required by section 1322(b)(5) to include interest.

22 E.g, In re Pracht, 464 B.R. 486, 490 (Bankr. M.D. Ga. 2012) (if school teacher was not permitted to make ongoing student loan payments during her chapter 13 plan, she would be in default and no longer eligible for approximately $50,000 in loan forgiveness under the Public Service Loan Forgiveness program).


25 In re Brown, 500 B.R. 255, 266 (Bankr. S.D. Ga. 2013) (§ 1322(b)(5) specifically applies to a cure in chapter 13 and is not subject to the limits on payment of post-petition interest found in § 1322(b)(10)); In re Webb, 370 B.R. 418, 422 (Bankr. N.D. Ga. 2007) (§ 1322(b)(5) is a specific provision applicable to cure of a default in a long term debt and is not controlled by the more general terms of § 1322(b)(10)); In re Freeman, 2006 WL 6589023 (Bankr. N.D. Ga. 2006) (§ 1322(b)(10) not applicable when debtor implementing cure and maintain provision of § 1322(b)(5)). See also In re Williams, 253 B.R. 220, 227 (Bankr. W.D. Tenn. 2000) (pre-BAPCPA decision, “The maintenance of ongoing payments necessarily involves the payment of post-petition interest.”).