

Discharging Non-Filing Co-Debtor Debt Under Chapter 13

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Introduction

During chapter 13 proceedings, both the debtor and the non-filing co-debtor are protected from their creditors by a stay. Once a bankruptcy petition is filed, section 362(a) of the Bankruptcy Code creates an “automatic stay” that operates by halting almost all actions by creditors against the debtor and his property to collect a prepetition debt.¹ In a chapter 13 bankruptcy case, section 1301(a) provides that the filing of the petition also automatically creates a co-debtor stay that generally prevents a creditor from taking any “act[ion], or commenc[ing] or continu[ing] any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt.”² Unless the co-debtor stay is modified or terminated, it will remain in effect until the debtor’s chapter 13 bankruptcy case is closed, dismissed, or converted to chapter 7 or chapter 11.³

Importantly, although the co-debtor stay protects a non-filing co-debtor during the debtor’s chapter 13 bankruptcy case, section 524(e) provides that the debtor’s discharge does not

¹ 11 U.S.C. § 362(a) (2012).

² *Id.* § 1301(a) (indicating two statutory exceptions including (1) debtor becoming liable during ordinary course of business and (2) case closing, being dismissed, or converting to chapter 7 or 11).

³ 11 U.S.C. § 1301(a)(2) (2012).

affect the co-debtor's contractual obligations.⁴ Therefore, once the debtor receives a discharge, section 524(e) leaves the non-filing co-debtor liable for the remainder of the co-signed debt. “[T]here is nothing in [section] 524 that prevents [the secured creditor] from asserting its rights against the non-filing co-debtor for the deficiency balance,”⁵ and therefore, a secured creditor is not barred from bringing an action against a non-filing co-debtor once the case is closed.⁶ This outcome is significant because “many cosigners are friends and relatives of the debtor, who want to and maybe even feel obligated to help their loved one.”⁷ Creating a “fresh start” for debtors is one of the fundamental goals of bankruptcy; however, allowing creditors to seek post-discharge repayment from non-filing co-debtors may frustrate this goal.⁸

This Article will discuss the general implications of co-debtor stays under a chapter 13 bankruptcy estate and some potential solutions to alleviate the informal pressure to re-pay non-filing co-debtors. Part I analyzes the current application of co-debtor stays in section 1301. Part II discusses co-debtor releases in relation to section 524. Finally, Part III concludes by identifying a possible way for chapter 13 debtors to eliminate, or at least reduce a non-filing co-debtor's post-confirmation liability.

I. Section 1301 generally protects non-filing co-debtors during bankruptcy proceedings from creditor's collection attempts

⁴ *Id.* § 524(e) (discharging a debtor does not affect the liability of any other entity related to the debt).

⁵ *In re Faulkner*, 07-81412, 2013 WL 2154790, at *2 (Bankr. C.D.Ill. May 17, 2013).

⁶ *Id.*

⁷ *In re Brown*, 266 B.R. 900, 908 (S.D. Ga. 2011).

⁸ *Grogan v. Garner*, 428 U.S. 279, 286 (1991).

Section 1301 imposes a co-debtor stay enjoining a creditor in a chapter 13 case from collecting a consumer debt from a non-filing co-debtor who cosigned the debt with the debtor.⁹ The co-debtor stay is designed to protect the debtor in bankruptcy and protects the non-filing co-debtor incidentally.¹⁰ In particular, without the protection of 1301, creditors would sue non-filing co-debtors, who in turn would pressure the debtor to pay the cosigned debt.¹¹ The co-debtor stay alleviates this problem by staying actions pertaining to cosigned debts.¹² Therefore, the non-filing co-debtor is shielded and will not pressure the debtor to make payments during the pendency of the debtor's bankruptcy case.¹³ However, Congress also wanted to protect the creditor and ensure the creditor did not lose the benefit of the bargain made with a cosigner.¹⁴

The co-debtor stay will not always protect a non-filing co-debtor throughout the debtor's entire bankruptcy case because some courts will lift the co-debtor stay if the debtor's plan does not account for the full debt owed.¹⁵ Essentially, if the property is losing value and the debtor does not account for the full debt owed in the plan, the court will likely allow a secured creditor to obtain relief from the non-filing co-debtor to protect its interests.¹⁶ For example, in *In re Jacobson*, the court lifted the non-filing co-debtor stay.¹⁷ There, the filing co-debtor's plan proposed to pay fifteen percent of the co-signed debt.¹⁸ The creditor moved to lift the non-filing

⁹ *In re Faulkner*, 07-81412, 2013 WL 2154790, at *3 (Bankr. C.D.Ill. May 17, 2013); 11 U.S.C 1301(a) (2012) (noting co-debtor stays apply on collections of "all or any part of a consumer debt of the debtor").

¹⁰ *Southeastern Bank v. Brown*, 266 B.R. 900, 907 (S.D. Ga 2001).

¹¹ *Id.*

¹² *Id.*

¹³ *See id.*

¹⁴ *See id.*

¹⁵ *See In re Jacobson*, 20 B.R. 648, 650 (9th Cir. B.A.P. 1982).

¹⁶ *See id.*

¹⁷ *Id.*

¹⁸ *Id.* at 649.

co-debtor stay in respect of the remaining eighty-five percent debt that was unaccounted for.¹⁹

In deciding to lift the co-debtor stay, the court reasoned “it would make little sense to defer such relief when it is known that the creditor will never receive the unprovided-for amount, under the plan from the debtor.”²⁰

Likewise, in *Southeastern Bank v. Brown*, the district court determined that the bankruptcy court should lift the co-debtor stay to the extent that the debtor’s plan did not for the full repayment of the cosigned debt at issue.²¹ There, the debtor’s father cosigned a bank loan for his son.²² The debtor’s proposed a plan that provided they would pay the entire cosigned debt, including interest. The bankruptcy court, however, only confirmed the plan after the debtor’s amended their plan to exclude the payment of interest.²³ The bankruptcy court also denied a secured creditor’s motion for relief from the co-debtor stay to collect the interest from the father. On appeal, the district court reversed, concluding that the co-debtor stay should be lifted to the extent that the debtor’s did not pay the cosigned debt in full with interest.²⁴ However, since the district court also concluded that the debtor’s plan could provide for the payment of post-petition interest, the court remanded the case to permit the debtor to propose a plan that provided for the full repayment of the cosigned debt.²⁵

II. Section 524(e) denies post-discharge protection to non-filing co-debtors

Courts have cited various policy considerations underlying the rule allowing creditors to collect from non-filing co-debtors upon the debtor receiving a discharge after the completion of

¹⁹ *Id.*

²⁰ *Id.*

²¹ 266 B.R. 900, 908 (S.D. Ga 2001).

²² *Id.* at 900.

²³ *Id.*

²⁴ *Id.* at 907.

²⁵ *Id.* at 910.

the debtor’s chapter 13 plan.²⁶ Although section 1301 protects non-filing co-debtors during bankruptcy proceedings, section 524(e) explicitly provides that the “discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for such debt.”²⁷ As a result, bankruptcy courts have widely held that a non-filing co-debtor cannot be discharged or released under the debtor’s chapter 13 plan — even if the creditor does not object to a plan that explicitly provides for such a discharge or release.²⁸ If a creditor is only partially repaid through the plan, the discharge will release only the debtor from having the repay the remaining unpaid cosigned debt.²⁹ The non-filing co-debtor will remain liable for the any outstanding contractual obligations owed to the creditor, including the repayment of the unpaid portion of the cosigned debt.³⁰ Indeed, the legislative history of section 1301 indicates that Congress wanted to protect creditors:

[The Creditor] is entitled to full compensation, including any interest, fees and costs provided for by the agreement under which the debtor obtained his loan. The creditor is simply required to share with other creditors to the extent that the debtor will repay him under the Chapter 13 plan. The creditor is delayed, but his substantive rights are not affected.³¹

²⁶ See *In re Faulkner*, 07-81412, 2013 WL 2154790, at *5 (Bankr. C.D.Ill. May 17, 2013); *In re Jackson*, 2-10757-JDW, 2012 WL 6623497, at *3 (Bankr. M.D. Ga. Dec. 18, 2012); *In re Harris*, 16 B.R. 371, 376 (Bankr. E.D. Tenn. 1982). However, in chapter 11 cases, the majority of courts have permitted a debtor to release a non-filing co-debtor if the creditor consents. See, e.g., *In re Arrowmill Dev. Corp.*, 211 B.R. 504 (Bankr. D.N.J. 1997). Some chapter 11 cases even allow discharge of co-debtors over a creditor’s objection. See *id.*

²⁷ 11 U.S.C. § 524(e) (2012).

²⁸ *In re Faulkner*, 07-81412, 2013 WL 2154790, at *5 (Bankr. C.D.Ill. May 17, 2013) (concluding “the debtor’s plan, no matter how clear and conspicuous, can only serve to release [the secured creditors]’s lien as to the debtor’s interest in the vehicle”); see also *In re Leonard*, 307 B.R. 611, 614 (Bankr. E.D. Tenn. 2004) (holding debtor was no longer liable to creditor, but non-filing co-owner remained liable); *First Fid. Bank v. McAteer*, 985 F.2d 114, 118 (3d Cir. 1993) (“[T]he creditor remains free to collect the full amount of the original obligation from any [non-filing] party”).

²⁹ *In re Leonard*, 307 B.R. 614.

³⁰ See *id.*

³¹ H.R. REP. NO. 95-595, at 426 (1977).

In addition, courts have cited various policy considerations underlying the rule allowing a creditor to collect from a non-filing co-debtor after the debtor has received a discharge.³² For example, in *In re Jackson*, the court opined that discharging a lien on a cosigned automobile even though the debtor did not propose to fully repay the cosigned debt would have been inequitable because the plan placed the lender in an unfair position of having the non-filing co-debtor receiving the benefit of the lien release as to her interest in the car without having to comply with section 1325(a)(5) in order to obtain such a release.³³ There, the debtor co-owned a car with his mother, with each party having one-half interest in the car.³⁴ Under the debtor's proposed plan, the debtor would pay secured creditor's claim with interest at a rate of five percent, instead of the contractual rate of twenty-eight percent, and the secured creditor would be required to release its lien against the car upon the debtor's discharge.³⁵ The secured creditor objected to the proposed plan, arguing that the secured creditor should not be required to release its lien because its claim was not going to be repaid in full.³⁶ While the court ultimately confirmed the debtor's plan, the court also held that the creditor would retain its lien against the non-filing co-debtor's interest in the car until the debt was repaid in full at the contract rate.³⁷

Similarly, in *In re Harris*, the court noted that preventing a creditor from collecting against a non-filing co-debtor after the debtor's discharge would unfairly deprive the creditor of the "benefit of the bargain" he made for a cosigner.³⁸ There, the debtor proposed to repay the

³² See *In re Faulkner* 2013 WL 2154790, at *5; *In re Jackson*, 2-10757-JDW, 2012 WL 6623497, at *3 (Bankr. M.D. Ga. Dec. 18, 2012); *In re Harris*, 16 B.R. 371, 376 (Bankr. E.D. Tenn. 1982).

³³ 2012 WL 6623497, at *3 (Bankr. M.D. Ga. Dec. 18, 2012).

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ 16 B.R. at 376.

creditor in full, including interest at the contractual rate.³⁹ In response, the creditor sought permission to proceed against the non-filing co-debtor notwithstanding a plan provision providing for the full repayment of the creditor's claim because the repayment period under the plan was longer than the period under the original loan. In denying the creditor's request, the court noted while the creditor was entitled to pursue the non-filing co-debtor to the extent that the debtor did not fully repay the creditor's claim, the co-debtor stay still prevented the creditor from collecting each payment from the non-filing co-debtor as it "became due" just as the creditor could before the debtor's bankruptcy case.⁴⁰ The court emphasized that the creditor was only required to wait for full payment under the plan and that the co-debtor stay did not alter the non-filing co-debtor's liability.⁴¹

III. A debtor's chapter 13 plan may be structured in a way that minimizes the post-discharge moral pressure from a non-filing co-debtor

Cosigned debts in chapter 13 cases present unique challenges because "many cosigners are friends and relatives of the debtor, who want and maybe even feel obligated to help their loved one."⁴² A fundamental bankruptcy tenant is giving an honest but unfortunate debtor a "new opportunity in life with a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."⁴³ The moral obligation to repay a close friend or relative may create pressure on the debtor to repay the debt even after the debtor receives a discharge. A debtor, however, may be able to structure his plan in such a way that eliminates, or at the very least minimizes, the non-filing co-debtor's obligation to repay the cosigned debt.

³⁹ *Id.* at 373.

⁴⁰ *Id.* at 378.

⁴¹ *See id.*

⁴² *In re Brown*, 266 B.R. 900, 908 (S.D. Ga. 2011).

⁴³ *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (quoting *Local Loan Co. v. Hunt* 292 U.S. 234, 244 (1934)).

In particular, under section 1322(b)(1), the debtor's plan may:

designate a class or classes of unsecured claims as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims.⁴⁴

As such, section 1322(b) may permit the debtor's plan to (1) designate a class of creditors consisting solely of the creditor that has a claim for a cosigned debt and (2) provide that such claim will have priority over the other non-priority unsecured claims filed against the debtor's estate. By doing so, the debtor will ensure that he repays as much of the cosigned debts as possible, which could eliminate, or at least reduce, the moral obligation to repay a non-filing co-debtor after the debtor receives a discharge. However, the debtor must still convince the court that such a plan does not unfairly discriminate against the other general unsecured creditors and that the plan meets the other requirements for confirmation.

Bankruptcy courts usually determine whether a plan unfairly discriminates using the four-part test articulated in *In re Leser*:⁴⁵ A court must look at (1) whether the discrimination has a reasonable basis; (2) if the debtor can carry out the 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.⁴⁶ A variation of the *Leser* test was adopted in *In re Husted*, which added a fifth factor: “[t]he difference between what creditors discriminated will receive as the plan is proposed, and the amount they would receive if there was no separate classification.”⁴⁷

⁴⁴ 11 U.S.C. § 1322(b)(1) (2012).

⁴⁵ 939 F.2d 669, 671–72 (8th Cir. 1991).

⁴⁶ *Id.*

⁴⁷ 142 B.R. 72, 74b (Bankr. W.D.N.Y. 1992).

Despite the plain language of the statute, courts have split as to whether section 1322(b)(1) permits a debtor to treat cosigned debts differently and whether such disparate treatment is subject to the unfair discrimination test. Specifically, courts have split as to “whether the ‘however’ clause is a carve-out from the unfair discrimination test.”⁴⁸ A majority of courts have held that a debtor may separately classify cosigned debt, but only if the treatment of the cosigned debt does not unfairly discriminate against the debtor’s other unsecured creditors. “The minority [of] courts . . . have held that the “however clause” is plain and unambiguous; that is, it clearly carves out codebtor consumer claims from the requirements of the unfair discrimination rule.”⁴⁹

The debtor’s ability to confirm a chapter 13 plan that provides for more favorable treatment of cosigned debts may depend on which approach the court applies. On one hand, if the debtor files in a jurisdiction that adopts the minority approach, the debtor will likely be able to confirm a plan that provides that holders of claims for cosigned debt will receive higher dividends than the holders of the other general unsecured claims. Yet, even the court applies the unfair discrimination test, the debtor may still be able to confirm such a plan because the unfair discrimination test allows a debtor to favor one class over another in order to continue vital relationships.⁵⁰

For example, in *In re Terry*, the court allowed preferential payments to doctors, hospitals, and other merchants that the debtor was required to deal with in the future in order to conduct

⁴⁸ See *In re Battista*, 180 B.R. 355, 357 (Bankr. D.N.H. 1995).

⁴⁹ See, e.g., *In re Renteria*, 470 B.R. 838, 842 (B.A.P. 9th Cir. 2012) (citing *In re Hill*, 255 B.R. 579, 580 (Bankr. N.D. Cal. 2000), *rev’d on other grounds*, 268 B.R. 548, 550 (B.A.P. 9th Cir. 2001); *In re Dornon*, 103 B.R. 61, 64 (Bankr. N.D.N.Y. 1989)).

⁵⁰ See *In re Terry*, 78 B.R. 171, 173 (Bankr. E.D. Tenn. 1987) (allowing greater payments to doctors, hospitals, merchants or others with whom debtor might deal with in future); *In re Todd*, 65 B.R. 249, 253 (Bankr. N.D.Ill. 1986) (reasoning maintaining confidence and harmony with co-worker was imperative to safe completion of job).

future business.⁵¹ The *Terry* court, however, cautioned that “[o]f course, there must be limits as to how financially self-serving a classification scheme can be.”⁵² Similarly, in *In re Todd*, the court allowed a police officer to pay off a debt he cosigned with his police partner.⁵³ There, the court reasoned that maintaining confidence and harmony within the police force was vital to the debtor continuing his job which he needed to complete his chapter 13 plan.⁵⁴ As such, the court determined that it was in the interest of all parties to allow preferential treatment for the cosigned debt with the police officer’s co-worker.⁵⁵ Thus, as *Terry* and *Todd* both demonstrate, even if the court applies the unfair discrimination test, the court may still confirm a plan that provides for preferential payment of the cosigned debt. Ultimately, if the debtor files in a jurisdiction that applies the unfair discrimination test, the debtor may want to heed the old adage that “pigs get fat, hogs get slaughtered” when proposing a plan that provides for more favorable treatment of cosigned debts because majority of courts will consider the degree of disparity when applying section 1322(b)(1).

On the other hand, if the debtor files in a jurisdiction that adopts the majority approach, it is less likely that the debtor will be able to confirm a plan that treats claims for cosigned debts more favorably than the other general unsecured claims because the court will require that such treatment satisfy the unfair discrimination test. Since the unfair discrimination does not apply, “the disparity in the dividend paid on codebtor consumer claims as compared to that paid on other unsecured claims should not be a factor in analyzing whether a plan complies with

⁵¹ 78 B.R. at 173.

⁵² *Id.* at 174.

⁵³ 65 B.R. at 253.

⁵⁴ *See id.*

⁵⁵ *See id.*

[section] 1322(b)(1).”⁵⁶ Therefore, if the debtor files in a jurisdiction that adopts the minority approach, the debtor should consider proposing a plan with a large disparity between the dividend paid on a claim for a cosigned debt and the dividends paid on the other unsecured claims.

Conclusion

Section 524(e) does not protect non-filing co-debtors. Upon discharge, the 1301 stay is lifted, and non-filing co-debtors become liable for any remaining debts. In chapter 13, requiring non-filing co-debtors to repay remaining debts is problematic because non-filing co-debtors are often family member or close friends. This circumstance creates awkward situations for the debtor. Although a debtor is not required to repay the remaining debt, a debtor may feel morally obligated to repay a family member, or loved one who cosigned for him.

A possible solution for problem is for the debtor to propose a chapter 13 plan that provides for the preferential repayment of the cosigned debt. Without the ability to create preferential classifications, “the desire to satisfy, outside the plan, co-signed obligations held by relatives and friends would hamper a debtor’s chances of successfully completing his or her plan.”⁵⁷ Courts, however, have split as to whether such disparate treatment pursuant to a chapter 13 plan runs afoul of the unfair discrimination test. As such, a debtor will only be able to confirm a chapter 13 plan providing such treatment if the court adopts the minority approach. Ultimately, in the majority of cases, a debtor with a cosigned debt may continue to face moral

⁵⁶ *In re Russell*, 503 B.R. 788, 797-98 (Bankr. S.D. Ohio 2013) (“[A] disparity—even a large one—between the dividend paid on [co-debtor] claims and the dividend paid on other unsecured claims does not itself constitute unfair discrimination.”).

⁵⁷ *In re Davis*, 101 B.R. 505, 507 (Bankr. S.D. Ohio 1989); *see also In re Cheak*, 171 B.R. 55, 58 (Bankr. S.D.Ill. 1994) (noting “desire to protect a co-signer with whom [debtor] has close personal ties might normally justify discriminatory treatment to prevent the debtor from jeopardizing his successful reorganization by attempting repayment outside the plan.”).

pressure from the non-filing co-debtor because the debtor's chapter 13 plan cannot pay the creditor holding the cosigned debt a greater dividend than will be paid to the other similarly situated creditors of the debtor.

