Student Loans and Bankruptcy: Recommendations for Reform

Editor's Note: *This month's Update features a written statement from ABI's Consumer Bankruptcy Committee, submitted for the Commission on Consumer Bankruptcy's hearing during the Winter Leadership Conference last December. It is available at ConsumerCommission.abi.org. In addition, to learn more about the Committee's program during ABI's Annual Spring Meeting mentioned herein, see the schedule starting on p. 38 or visit abiasm.org.*

The Consumer Committee has a diverse membership. It includes practitioners who represent debtors in chapter 7 and 13 cases; practitioners who represent creditors in consumer bankruptcies, including student loan servicers; chapter 7 and chapter 13 trustees; and attorneys who represent trustees. We have all seen the effects of burdensome student loans. While we cannot do much about the root causes of skyrocketing education costs and diminishing public support for institutions of higher learning, we can try to suggest ways in which the bankruptcy process can aid the honest-but-unfortunate student loan debtor.

History of § 523(a)(8) Legislation

It is important to recall that prior to 1976, student loans were fully dischargeable. The federal student loan program was in its infancy. The National Defense Student Loan Program was established in 1958; the Federal Insured Student Loan Program was enacted in 1965. Congress, however, perceived that a growing number of graduates were filing for bankruptcy relief shortly after graduation for the specific purpose of discharging student loans.[1]

In 1978, 11 U.S.C. § 523(a)(8) was born. Exceptions from discharge included:

> A governmental unit, or nonprofit institution of higher education, for an education, for an educational loan, unless[2]
>
> > A. such loan first became due before five years before the date of the filing of the petition; or
> > B. excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents.

Section 523(a)(8)(B), allowing discharge of student loans in the case of "undue hardship," was little discussed and was apparently inserted as a compromise.[3] In 1979, § 523(a)(8) was expanded to include programs funded in whole or in part by a governmental unit or nonprofit for an educational loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a nonprofit institution of higher education, unless

> A. such loan first became due five years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition; or
> B. excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and debtor's dependents.[4]

The section was further amended by the Bankruptcy Amendments and Federal Judgeship Act of 1984:[5]

> ... for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution, unless
>
> > A. such loan first became due before five years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition; or
> > B. excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents.

In 1990, under the Crime Control Act of 1990, Congress lengthened the time period for discharge from five years to seven years. By simply removing the words "of higher education," Congress opened the door to the protection of private loans:

> ... for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend unless —
>
> > A. such loan, benefit, scholarship, or stipend overpayment first became due more than [seven] years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition; or
> > B. excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor or the debtor's dependents.[6]

Next, Congress eliminated the possibility of student loan discharge of government loans unless they would impose "undue hardship":

> ... for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in

1 *See generally* Janice E. Kosel, "Running the Gauntlet of 'Undue Hardship': The Discharge of Student Loans in Bankruptcy," 11 *Golden Gate U. L. Rev.* 457 (1981).
2 P.L. 95-598, Nov. 6 1978. Pub. L. No. 95-598 (Nov. 6, 1978).
3 Kosel, "Running the Gauntlet," *supra* n.1 at 465.
4 P.L. 96-56 (8/14/79) Pub. L. No. 96-56 (Aug. 14, 1979).
5 Pub. L. No. 98-353, 98 Stat. 333 (July 10, 1994).
6 Pub. L. No. 101-647, 104 Stat. 4789 (Nov. 29, 1990).

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part by a government unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend, unless excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents.[7]

Finally, BAPCPA, inexplicably, extended the § 523(a)(8) exception to private and for-profit educational loans:

523(a) Exceptions to discharge…

(8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for —

(A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or

(A)(ii). an obligation to repay funds received as an educational benefit, scholarship, or stipend; or

B. any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1996, incurred by a debtor who is an individual.[8]

While Congress was enlarging the nondischargeability provision of the Bankruptcy Code, it was simultaneously expanding loan servicers' ability to collect on debt by allowing garnishment of wages and even Social Security benefits. The cost of education also skyrocketed. College costs rose by 50 percent, adjusted for inflation between 1990 and 2005.

Meanwhile, courts have differed widely over the meaning of "undue hardship," with the result being that in some jurisdictions it is almost impossible to obtain a discharge of student loan debt.

Judicial Interpretation of "Undue Hardship"

Current law makes it very difficult to discharge any amount of student loan debt. With the high default rate on this debt and the need to preserve this important resource for future students, it is time to explore options for dealing successfully with student loan debt in bankruptcy proceedings.

Under § 523, to discharge student loans a debtor must show that "excepting such debt from discharge ... would impose an undue hardship."[9] Congress failed to provide guidance to interpret the meaning of "undue hardship." As a result of a circuit split, there are two tests utilized by the circuit courts to determine whether a debtor is suffering from an undue hardship: the *Brunner* test[10] and the totality-of-the-circumstances test.[11] The *Brunner* test is more widely adopted (nine circuit courts apply *Brunner*),[12] which requires the debtor to demonstrate the following:

(1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans.[13]

Each of these are a "prong," meaning that instead of a factor test where failing to meet one factor is not necessarily dispositive, to receive a discharge under *Brunner*, a debtor must meet each prong.[14] The second test, created and applied by the Eighth Circuit, is the "totality of the circumstances" test,[15] which requires examination of a list of nonexhaustive factors:

(1) the debtor's past and present financial resources and those the debtor can reasonably rely on in the future, (2) the reasonable necessary living expenses of the debtor and the debtor's dependents, and (3) any other relevant facts and circumstances surrounding each particular bankruptcy case.[16]

Because this test allows courts to consider additional circumstances, does not require debtors to show additional circumstances and does not require debtors to show good-faith efforts to repay the loans, the totality-of-the-circumstances test is generally considered a more lenient test.[17] However, with the majority of circuits applying the *Brunner* test, and with some of those circuits indicating that debtors must show a "certainty of hopelessness"[18] in order to discharge a debt, student debtors ... face considerable obstacles in discharging this debt.

Discharging Student Loan Debt Through a Chapter 13 Plan

Debtors who propose a repayment plan under chapter 13 find it very difficult to repay meaningful distributions to student loan creditors during the course of a chapter 13 plan. The Bankruptcy Code, in § 1322(b)(1), provides that a plan "may designate a class or classes of unsecured claims, as provided in Section 1122 of this title."

7 Health Professions Education Partnerships Act of 1998, Pub. L. No. 105-392, 112 Stat. 3524 (Nov. 13, 1998).
8 Pub. L. No. 109-08 (Oct. 17, 2005).
9 Heather Boushey, "Student Debt: Bigger and Bigger," Center for Economic and Policy Research Briefing Paper (September 2005), *available at* cepr.net/documents/publications/student_debt_2005_09.pdf (unless otherwise specified, all links in this article were last visited on Feb. 9, 2018).
10 *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395, 396 (2d Cir. 1987).
11 *Long v. Educ. Credit Mgmt. (In re Long)*, 322 F. 3d 549, 554-55 (8th Cir. 2003).
12 *See Brunner*, 831 F.2d at 396; *Oyler v. Educ. Credit Mgmt. Corp. (In re Oyler)*, 397 F.3d 382, 385 (6th Cir. 2005); *Educ. Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302, 1307 (10th Cir. 2004); *United States Dep't of Educ. v. Gerhardt (In re Gerhardt)*, 384 F.3d 89, 91 (5th Cir. 2003); *Hemar Ins. Corp. v. Cox (In re Cox)*, 338 F.3d 1238, 1241 (11th Cir. 2003); *Ekenasi v. Educ. Res. Inst. (In re Ekenasi)*, 325 F.3d 541, 546 (4th Cir. 2003); *Brightful v. P.H.E.A.A. (In re Brightful)*, 267 F. 3d 324, 327 (3d Cir. 2001); *Rifino v. United States (In re Rifino)*, 245 F.3d 1083, 1087 (9th Cir. 2001); *Matter of Roberson*, 999 F. 2d 1132, 1135 (7th Cir. 1993).
13 *Brunner*, 831 F.2d at 396.
14 *In re Frushour*, 433 F.3d 393, 404 (4th Cir. 2005) (recognizing that court cannot discharge student loans under *Brunner* without proving all three prongs).
15 *Long v. Educ. Credit Mgmt. (In re Long)*, 322 F.3d 549, 554-55 (8th Cir. 2003).
16 *Id.*
17 *See* Sarah Edstrom Smith, "Should the Eighth Circuit Continue to Be the Loan Ranger? A Look at the Totality-of-the-Circumstances Test for Discharging Student Loans Under the Undue Hardship Exception in Bankruptcy," 29 *Hamline L. Rev.* 601, 633 (2006) (describing totality-of-the-circumstances test as a more lenient test).
18 *Oyler v. Educ. Credit Mgmt. Corp. (In re Oyler)*, 397 F.3d 382, 386 (6th Cir. 2005) (requiring that there be "certainty of hopelessness" in showing that additional circumstances exist indicating that this state of affairs is likely to persist for significant portion of repayment period of student loans).

That designation, however, may not lead to unfair discrimination between the classes of claims so designated. 11 U.S.C. § 1322(b)(1).

Unless the chapter 13 debtor can show that discriminatory treatment between similarly situated creditors is necessary for the debtor to successfully complete his chapter 13 plan, separate classification of student loans and other general unsecured claims is seldom permitted.[19] In many cases, however, a maintenance payment on the student loan debt has very little impact on creditors of the same class.

For debtors with a large student loan balance, adding the balance of the debt to the unsecured pool to be paid might actually have a more negative impact on the amount to be repaid to all unsecured creditors. Often, the calculation favors a small separate maintenance payment on the student loan, rather than inclusion in the class for receipt of *pro rata* distributions, thereby driving down the dividend to general, unsecured creditors.

Income-Based Repayment for Student Loan Debt

There are several different income-based repayment plans, each of which caps the amount that a student loan borrower has to repay to the federal government at a fixed rate based on the borrower's discretionary income.[20] Further, these plans drive up the borrower's standard repayment plan from 10 years to 20 or 25 years.[21] Different programs include Income-Based Repayment (IBR), Pay As You Earn (PAYE), Revised Pay As You Earn (REPAYE) and Income-Contingent Repayment.[22]

Under the IBR plan and depending on when the borrower first started taking out the loans, the loan repayment will either be capped at 10 or 15 percent of the borrower's discretionary income.[23] However, the qualifying borrower must suffer from a partial financial hardship, meaning that a borrower's monthly payments on the standard 10-year plan could not be under the amount that the IBR plan caps their income.[24] Finally, after a 20- or 25-year term of repaying loans, any remaining debt is forgiven — even if the borrower is working for a private for-profit company.[25] Unfortunately, all the additional debt forgiven is taxable income, and forgiveness under this option can create a substantial tax burden.[26]

Debtors should apply for one of the repayment plans before or as they enter bankruptcy. A reasonable monthly repayment amount should be continued while the debtor completes a chapter 13 plan. Maintaining a forgiveness repayment program during bankruptcy effectuates a true fresh start and balances the policy objectives of the bankruptcy system and the expressed governmental interest in maintaining a viable student loan program. It is advisable to have the student loan repayment made through the trustee to ensure that the payment is kept current and to ensure complete accounting records.

The [U.S.] Bankruptcy Court in the Middle District of North Carolina has signaled that student loan debt should be paid during the course of a chapter 13 plan, subject to certain parameters to ensure fairness to the student loan creditor and other unsecured creditors.[27] For example, the debtor should apply for and enroll in an income-driven repayment plan. The bankruptcy plan should not provide for discharge for any portion of the student loan debt. The plan should avoid unfair discrimination in favor of the student loan creditor (*i.e.*, a disproportionate advantage to the student loan creditor). The debtor must also notify the trustee of any changes in repayment of the student loan or any default under the repayment plan. The court's approval of such chapter 13 plan ensures transparency while allowing a debtor to participate in a favorable repayment program.

In the Austin Division of the Western District of Texas, a working group will soon propose a program similar to the North Carolina procedure. The working group includes the local chapter 13 trustee, attorneys who represent consumer debtors in bankruptcy, and the local U.S. Attorney on behalf of the U.S. Department of Education (DOE). The recommendation procedure will include the chapter 13 plan language previously approved by the [DOE].

Pending Legislation

There is a plethora of legislation introduced in this Congress, as in the last Congress, intended to provide relief to the beleaguered student loan debtor. The bills range from attempting to ensure a better understanding of the student loan process,[28] to providing emergency loan refinancing,[29] to allowing employers to help repay student loans.[30]

Two bills directly address the dischargeability of student loans in bankruptcy. The Discharge of Student Loans in Bankruptcy Act of 2017[31] simply seeks to strike § 523(a)(8) altogether. Passage ... would allow the discharge of student loan debt in bankruptcy and return the law to its pre-1976 status. The bill currently has 17 cosponsors.

The second bill, Private Student Loan Bankruptcy Fairness Act of 2017,[32] seeks to amend § 523(a)(8) to allow private education loans to be discharged regardless of whether the debtor demonstrates undue hardship. The bill has 22 cosponsors. It would essentially return the state of the law to its pre-1984 status. It leaves the "undue hardship" language unchanged.

There is some bipartisan support for each of these two bills, although most the sponsors are Democrats. In addition to pending legislation, the current administration has announced plans to make changes regarding student loan forgiveness. The [DOE] has not approved any applications for

19 *Groves v. LaBarge (In re Groves)*, 39 F.3d 212, 215 (8th Cir. 1994).
20 Teddy Nykiel, "Find the Best Student Loan Repayment Plan for You," *Nerdwallet* (March 31, 2017), *available at* nerdwallet.com/blog/loans/student-loan-repayment-plans.
21 *Id.* However, if a borrower qualifies for PSLF, then the loans will be forgiven after 10 years of payments made while working for a public service entity.
22 *Id.*
23 *See* "Income-Driven Repayment Plans for Federal Student Loans," Federal Student Aid Website 1 (February 2016) (indicating that new borrowers after July 2014 would have the amount capped at 10 percent of their monthly income).
24 Brianna McGurran, "Income-Based Repayment: How It Works and Whom It's Best For," *Nerdwallet* (Dec. 21, 2016), *available at* nerdwallet.com/blog/loans/student-loans/what-is-income-based-repayment.
25 *Id.*
26 Taxability of Student Loan Forgiveness, FinAid, *available at* finaid.org/loans/forgivenesstaxability.phtml.
27 *In re Buchanan (Order Confirming Chapter 13 Plan)*, Case No. B-14-51161 (Bankr. M.D.N.C. June 12, 2015).
28 *See, e.g.*, College Transparency Act, H.R. 2434, 115th Cong. (2017-18).
29 *See, e.g.*, Bank on Students Emergency Loan Refinancing Act, S. 1162, 115th Cong. (2017-18).
30 *See, e.g.*, Employer Participation in Student Loan Assistance Act, H.R. 795, 115th Cong. (2017-18).
31 H.R. 2366, 115th Cong. (2017-18).
32 H.R. 2527, 115th Cong. (2017-18).
33 "PBS News Hour," July 26, 2017, 7:39 p.m.

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student loan forgiveness for fraud since the current President took office. There are about 8,000 applications pending.[33] The DOE is preparing a new regulation. There are also reports of discussions to change other student loan forgiveness and student loan repayment plans.[34]

Observations and Recommendations

Student Loan Debtors Need More Access to Legal Advice

Some consumer attorneys are engaging in very creative litigation to obtain relief for their student loan debtors. Many debtors, however, cannot afford or have no access to attorneys who are willing and able to bring dischargeability actions for student loan debt. In fact, the problem of access to bankruptcy legal advice is not limited to student loan debt.

The Consumer Committee is working on a program for the Annual Spring Meeting in partnership with the Ethics Committee to address possible ways to enlarge access of consumer debtors to the bankruptcy process and competent legal advice.

Payment of Some Student Loan Debt Through Chapter 13 Plans

The Middle District of North Carolina and now the Austin Division of the Western District of Texas have developed procedures to allow payment of student loan debt through a chapter 13 plan. While it is limited to loans paid through an income-based repayment program, it can provide some relief. Other districts should be encouraged to do the same. Further, now that some spade work has been done, consumer debtor practitioners should try to adapt these established procedures to their local practice. Of course, it requires that the student loan debtor apply for one of the income-based repayment plans before filing for bankruptcy protection.

Court-Sponsored Student Loan Debt Mediation

As promising as it is, payment of student loans through chapter 13 plans would only assist some debtors with some loans. A practitioner who represents a student loan servicer has suggested that mediation appears to be very effective in reducing or discharging student loan debt. In view of the fairly successful mortgage mediation programs, perhaps a similar program aimed at student loan debt would work. Many bankruptcy courts already encourage mediation of adversary proceedings. Possibly a local rule requiring mandatory mediation for student loan dischargeability actions would serve the same purpose.

Amend § 523(a)(8)

There are two bills pending currently. H.R. 2366 seeks to strike § 523(a)(8) from the Bankruptcy Code and allow student loan debt to be treated as any other unsecured debt. H.R. 2527 would amend § 523(a)(8) to allow private education loans to be discharged through bankruptcy.

Striking § 523(a)(8) goes too far. There is a reason to discriminate in favor of federal student loan programs. Student loan repayment affects future generations of students. The purpose of the student loan programs has always been to ensure a supply of well-trained professionals and technical people and to open up educational opportunities to every person who would benefit.

On the other hand, since it is a mystery why BAPCPA expanded § 523(a)(8) protection to private loans, H.R. 2527 ought to be endorsed. It should go a little further, however, and strike "undue" from the "undue hardship" language. This time, Congress should add some guidance for the hardship test. Hardship should be based on the totality of the circumstances, including the debtor's past, present and predictable future financial resources and the reasonable, necessary living expenses of the debtor and debtor's dependents.

It seems that an amendment to the statute is necessary. It has become all too clear that DOE policies can be changed with the stroke of a pen and a change in administrations. Student loan debtors should be able to rely on repayment or discharge policies.

Amend § 1322(b)

The committee recommends a revision to § 1322(b) to carve out student loan debt similar to the current treatment of co-signed obligations. The revised statutory language would allow separate classification and treatment of student loan debt for a debtor enrolled in an income-driven repayment plan, as defined under the Higher Education Act. abi

34 Martha Danilova, "Devos May Only Partly Forgive Some Student Loans," *Las Vegas Rev. J.*, Oct. 29, 2017 at 10A.