

The Graduate...Is Broke: The Effect of Student Loans on the Economy, Society and the Practice of Bankruptcy Law

Prof. Susan E. Hauser, Moderator

*ABI Resident Scholar; Alexandria, Va.
North Carolina Central University School of Law; Durham, N.C.*

Prof. Daniel A. Austin

Northeastern University School of Law; Boston

Ariane R. Holtschlag

InnovaLaw, P.C.; Orland Park, Ill.

Mark E. Shure

Latimer LeVay Fyock LLC; Chicago

DISCOVER



eLearning

elearning.abi.org

Earn CLE credit on demand



Cutting-edge Insolvency Courses

With eLearning:

- **Learn from leading insolvency professionals**
- **Access when and where you want—even on your mobile device**
- **Search consumer or business courses by topic or speaker**
- **Invest in employees and improve your talent pool**

Expert Speakers, Affordable Prices

elearning.abi.org

ABI's eLearning programs are presumptively approved for CLE credit in CA, FL, GA, HI, IL, NV, NJ, NY (Approved Jurisdiction Policy), RI and SC. Approval in additional states may be available for some courses. Please see individual course listings at elearning.abi.org for a list of approved states.

44 Canal Center Plaza • Suite 400 • Alexandria, VA 22314-1546 • phone: 703.739.0800 • abi.org

Join our networks to expand yours:



© 2012 American Bankruptcy Institute. All Rights Reserved.

**The Graduate...Is Broke: The Effect of Student Loans on the
Economy, Society and the Practice of Bankruptcy Law**

Panelists:

Prof. Susan E. Hauser, Moderator
ABI Resident Scholar; Alexandria, VA
North Carolina Central University School of Law; Durham, NC

Prof. Daniel A. Austin
Northeastern University School of Law; Boston, MA

Ariane R. Holtschlag
InnovaLaw, P.C.; Orland Park, IL

Mark Shure
Latimer LeVay Fyock LLC; Chicago, IL

Numbers, Drivers, and Profiles of Student Loan Debt

© 2012

By: Prof. Daniel A. Austin¹

Thirty-seven million Americans--some 19.9% of American households—owe student loans. The average debt load for a four-year college graduate in the class of 2010 was more than \$25,250. Students in graduate school borrow much more, and averaging over \$43,500, and individual loan debt exceeding \$150,000 is not uncommon. Many middle-aged and senior citizens also have student loan debt, in addition to parents and relatives who have co-signed student loans. As of 2012, less than 40% of student loan debt was in repayment status according to the original terms, and a recent study finds that approximately 21% of current student loans are delinquent or in default. This article will examine the numbers and drivers of student loan debt, overview the student loan industry, and provide personal profiles of student loan debts.

I. Spiraling Education Cost, Spiraling Education Borrowing

Since 1990, the cost of education has mushroomed far in excess of the cost of living. In 1990-91, the cost of tuition, room, and board at an average four-year public college was \$8,403, and \$21,218 for a private four-year college. As of 2000-01, this increased to \$10,609 for a public college, and \$26,795 for a private one. By 2011-12, these numbers were \$17,131 and \$38,589, respectively. For another perspective, in January 2000 the cost of education and the consumer price index were both at 100. As of July 2012, CPI stood at 135, while the cost of education had increased to 196. The cost of a college education has risen by three times the cost of inflation since 1983. Overall, the cost of higher education in America is among the highest in the world.

As education costs have spiraled, education borrowing has also spiraled. In 2000-01, total education loan debt stood at \$43,453,000. As of the first-quarter 2012, federal student loan debt was approximately \$904 billion with private loans adding another \$150 billion, surpassing both consumer credit card debt (\$679 billion) and auto loan debt (\$737 billion). Students borrowed \$103.9 billion in 2010-11 alone. As of 2011, borrowing for education at non-profit schools averaged 42% of the cost of an education, while the borrowing rate at 2-year for-profit schools may be as high as 98%. The Department of Education expects new federally guaranteed student loans in 2013 to total \$154.4 billion. Yet the fastest growth is for students at for-profit schools, even though students at these schools have a lower graduation rate, higher debt, and higher tendency to default on loans.

In 1989-1990, students graduating from public four-year colleges averaged \$8,200 in debt, while average debt at private colleges was \$10,600. In 1999-2000 the amounts increased to \$15,100 and \$16,500, respectively. But over the decade 2000-02 through 2010-11, federal loans per full-time undergraduate student shot up at an average rate of 5% a year after adjusting for inflation, for a total increase of 57% for the decade. As of 2010, 54% of students at public four-year colleges had borrowed for education, with an average debt of \$22,000. Of students earning

¹ Association Professor, Northeastern University School of Law; d.austin@neu.edu

Chicago Consumer Bankruptcy Conference

bachelor's degrees at private non-profit institutions, about 66% had borrowed for their education, and the typical debt load was \$28,100. Averaging all four-year non-profit schools, the mean debt per student in 2010 was \$25,250. A typical undergraduate student received \$4,907 in federal loans in 2010-11, while the average graduate student received \$16,423 in federal loans during the same period. For graduates obtaining professional degrees, the borrowing rate was much higher, with some 79% having obtained loans for school as of 2007-2008. The plight of law school graduates, with an average debt load of \$98,500 at graduation in 2010, has been well-noted in the press. And none of these numbers include private loans, which are more difficult to track.

It is not just younger people who go into debt for education. In recent years, education borrowing by people ages 35 to 49 has also grown rapidly. In addition, parents are incurring debt to cover college costs for their children. In 1992-93, 5.6% of parents took out loans for their children's education. By 2010, that number had risen to 17%. Loans to parents for their children's college education account for approximately \$100 billion, or about 10% of the estimated \$1 trillion in education debt. And many older people remain saddled with debt from their own college years. One study finds that people aged 60 and older hold \$36 billion in student loan debt, of which some 10% is delinquent.

Borrowing rates are different for-profit programs than at public and private institutions. For example, as of 2009, only 15% students who started post-secondary studies at a four-year for-profit institution had earned a degree. And of those graduates, two-thirds had debt over \$28,000. In contrast, for dependent students who started at a public four-year institution, 64% had earned a bachelor's degree, but only 14% of them borrowed more than \$28,000. In 2008, proprietary students studying for an associate's degree had median federal debt of approximately \$14,045, compared to median debt level of \$7,125 for students at private, not-for-profit schools. Similarly, students seeking a bachelor's degree at proprietary four-year schools had median debt of \$23,874, more than double the debt level of \$11,580 for students at private non-profit schools, and five times the debt of \$4,968 for students at public schools.

Student loan debt is clearly concentrated in young adults. Of people under the age of thirty, 40.1% have student loan debt, while among people between the ages of thirty and thirty-nine, 25.1% have student loan debt. In contrast, only 7.4% of people over forty have student loan debt. Overall, \$580 billion of the \$870 billion federal student loan balance is owed by people under the age of forty.

II. The Student Loan Industry

The student loan industry is a massive, profit-making enterprise. With loan assets of \$1 trillion, and lending in 2013 exceeding \$150 billion, the student loan business eclipses almost any private industry in annual sales.

A. Federal Loan Programs

Federal funding for student loans began as a response to the Cold War and the launch of the Soviet Sputnik satellite in 1957. Subsequent expansion included grants and loans to assist medical and health program students, the Guaranteed Student Loan Program (1965), Higher

American Bankruptcy Institute

Education Amendments Act (1972) to provide grants and loans for junior colleges, trade schools, and career colleges, the Middle Assistance Act (1978) offering education grants and loans to middle-class families, and the Parent Loans for Undergraduate Students Program (1981) which allowed families of all income levels to obtain loans for dependent students, albeit at higher interest rates. The GSL program was revised in 1988 to become the Federal Stafford Loan Program. Its primary purpose was to provide low-cost loans guaranteed by the U.S. government. In 2007, the College Cost Reduction and Access Act increased Pell grant amount, reduced interest rates on subsidized student loans, and capped loan repayment at 15% of discretionary income. One of the basic policies of federal education grant and loan programs is to make college accessible regardless of economic background.

Through 1993, private banks made student loans under the Stafford program, and the Department of Education would subsidize loans and reimburse banks if borrowers defaulted. The Stafford program was modified in 1993 with the creation of the Federal Family Education Loan Program (FFELP) and the William D. Ford Federal Direct Loan program. FFELP continued the policy of students obtaining federally guaranteed loans through banks. However under the Ford loan program, students borrowed funds directly from participating schools, which received funds from the Department of Education. From 1993 to 2010, applicants for a Stafford loan could get their loans through either the Ford program or FFELP. Approximately 80% of all federal student loans were made through FFELP. Lenders under FFELP made loans without regard to the student's creditworthiness. The federal government guaranteed the loan against default. Today, federal loans constitute about 75% of all education loans, and 93% of all new loans made in 2010-2011.

To entice private lenders to make loans to students, FFELP lenders were promised a guaranteed rate of return called the "special allowance rate." The special allowance rate was based upon an average of 3-month commercial paper rates, plus certain factors for loans in repayment or in deferment or grace. This was in addition to the federal loan guarantee if the borrower defaulted.

A major restructuring of student loans took place in 2010 with the enactment of the Health Care and Education Reconciliation Act. That act contains the Student Aid and Fiscal Responsibility Act ("SAFRA"). A key provision of SAFRA is to remove private banks as middlemen in the student loan process, which is intended to save the cost of subsidies and guarantees paid to banks, and then redirect that savings to need-based grants. Loans are now made directly to students through the U.S. Department of Education, ending the FFELP program. For loans made before 2010, lenders receive the higher of the special allowance rate or the student interest rate set by the government for new student loans. If the student rate is lower than the special allowance rate, the government makes up the difference. In the event that the student rate is higher, the lender pays the difference to the government.

Currently, the federal government originates four types of loans: Subsidized Stafford, Unsubsidized Stafford, PLUS and Consolidation loans. The Subsidized Stafford loan offers the lowest interest rate, presently at 3.4%. Borrowers must meet a financial needs test based on family income, and after July 1, 2012 graduate and professional students were no longer eligible for these loans. The three other types of loans are available to borrowers at any income level.

Chicago Consumer Bankruptcy Conference

Previously, the government paid the interest on the loan during the time the student was in college, as well as a six-month grace period following graduation, and for any deferment periods. However, as of July 1, 2012 students are charged interest immediately following graduation.

Unsubsidized Stafford loans are made without regard to financial need. The interest rate was fixed at 6.8% for loans made after July 1, 2006, and the government does not pay any of the interest. Students can defer payment of interest while in school, but accrued interest will be capitalized at the start of repayment. PLUS Loans (Parents Plus) are available to parents with dependant undergraduate, graduate, and professional degree students. Interest is 7.9% and accrues immediately upon disbursement of the loan. Plus Loan applicants may not have any adverse credit history. Consolidation Loans are available for borrowers with existing loans in order to combine the loans and extend payment schedules and terms based on their total existing loans. The interest on a Consolidation Loan is based upon the weighted average of all loans being consolidated, rounded up to the nearest 1/8 of 1%.

Subsidized and Unsubsidized Stafford Loan amounts are capped as follows:

	Annual Limits	Annual Limits
Dependant Undergraduates	Stafford	Total (Stafford & Unsubsidized Stafford)
First-Year Student	\$3,500	\$5,500
Second-Year Student	\$4,500	\$6,500
Third-Year Student	\$5,500	\$7,500
Independent Undergraduates		
First-Year Student	\$3,500	\$9,500
Second-Year Student	\$4,500	\$10,500
Third-Year Student	\$5,500	\$12,500
Graduate Students	\$8,500	\$20,500
	Aggregate Limits	Aggregate Limits
Dependant Undergraduates	\$23,000	\$31,000
Independent Undergraduates	\$23,000	\$57,500
Graduate Students	\$65,500	\$138,500

Education lending is an income-producing endeavor for the federal government. Profit is made on the spread between the government's borrowing rate, presently around 1%, and the subsidized lending rate, currently at 3.4% for the lowest rate Subsidized Stafford loan and increasing with other types of loans. This is in addition to the origination fee of 1%. The Department of Education anticipates that federal subsidized student loan activity (including new loans and consolidation of existing loans) will generate \$38.9 billion in revenue for the government in 2012, and approximately \$36.8 billion in 2013. The federal government expects to earn 20.08% on each dollar of loans originated in 2013.

B. *Non-federal Student Loans*

American Bankruptcy Institute

In addition to federal education loans, private lenders also loan money to students. About 2.9 million students currently have private loans. Private loans peaked at \$22 billion in 2007-2008, but dropped to \$6 billion by 2010-2011 due to increased caps on federal loans and tighter lending standards. Currently, private loans constitute approximately 14% of total student borrowing. The total of private loans is \$150 billion.

A student might take out a non-federal loan if he has reached the annual or aggregate federal loan cap. Unlike federal loans, most of these are priced according to credit-worthiness standards, and there is no cap on interest rates. Interest rates on private loans are usually much higher than federal loans, with some as high as 15% or more. Many private loans include adjustable interest rates without caps that can be adjusted without notice. There are no loan limits, but there also no deferments, income-contingent repayment, or any of the other relief available in federal loan programs. Private loans are considered riskier than federally guaranteed loans, yet more than half of student borrowers fail to max out government loans before incurring private loans. Overall, student lending is a highly profitable business.

The largest private lender is Student Loan Marketing Association (Sallie Mae). Established in 1972, Sallie Mae is financed by borrowing money, then relending to students at a higher rate. Student Loan Asset Backed Securities (“SLABS”) were invented by Sallie Mae in the early 1990s. These are securitized portfolios of student loans, similar to Fannie Mae securities backed by home mortgages. The assets behind the securities are the loans themselves. In 1990 there were \$75.6 million Sallie Mae securities in circulation, in 2010 annual trading was \$250 billion. Up to 30% of student debt is securitized.

Private lenders have been accused of offering schools incentives such as paid trips for financial aid officials and guests to conferences in vacation spots, gifts awarded through raffles, “set-asides” (loans for international students and those with poor credit), and even cash payments directly to schools in order to encourage schools to steer students to a lender’s loan programs. Reform measures subsequently curbed some, but not all of these abuses.

C. Student loans and higher education costs: cause, effect, and cause again

Some commentators assert that the broad availability of education credit has itself fueled the increase in education costs. Known as the “Bennett Hypothesis,” it postulates that increases in education credit creates more students with funds to go to college, so schools raise tuition in order to capture the increase in federal money. It was first articulated by William Bennett, Education Secretary under Ronald Reagan, who wrote in a 1987 op-ed piece, “[i]ncreases in financial aid in recent years have enabled colleges and universities to raise their tuitions, confident that the Federal Government loan subsidies would help cushion the increase.” As colleges charge more, school loan credits must increase in order to keep pace with education costs, and the cycle repeats. Higher tuition and loans to pay them have spurred building booms at university across the U.S., and allowed programs that utilize federal loan funds to charge far more than programs that do not. Proponents of the Bennett Hypothesis assert that the upward trend in education costs will not be contained as long as low-cost student loans are available.

Chicago Consumer Bankruptcy Conference

III. Student Loan Borrowers – Numbers and Profiles

A. Student Loan Debts and Undue Hardship Discharges

I reviewed approximately 200 randomly selected Chapter 7 cases filed each year from 2004 to 2011, and 130 randomly selected Chapter 13 cases filed each year during the same period. The table below shows the percentage of cases in which the debtor reported student loan debt, and the average amount of student loan debt per debtor.

Year	Chapter 7		Chapter 13	
	Percent w/ student debt	Average student loan debt	Percent w/ student debt	Average student loan debt
2004	19	\$26,000	14	\$18,335
2005	18	\$20,262	15	\$21,326
2006	18.2	\$20,102	21	\$10,733
2007	25.2	\$22,870	22	\$24,159
2008	20	\$32,702	20	\$19,578
2009	22	\$30,894	22	\$28,485
2010	20.7	\$33,967	26	\$18,204
2011	24.5	\$29,525	20	\$28,315

While there are some anomalous results (for example, significant declines in student debt reported in Chapter 13 cases in 2006 and 2010), overall the above data shows a steady increase in both the percentages of debtors reporting student loan debt on their chapter 7 and chapter 13 schedules, and in the average amount of student loan debt per debtor. Clearly, student loan debt is an increasing factor in consumer bankruptcy.

My review of bankruptcy cases also revealed that debtors overwhelmingly self-select to not discharge student loan debt in bankruptcy. Of the 1,622 Chapter 7 cases and 1,043 Chapter 13 cases that I reviewed, only two Chapter 7 debtors and one 13 Chapter debtor sought to have their student loans discharged. In a 2009 Chapter 7 case, the debtor received a discharge of \$79,000 in student loans by establishing undue hardship as a result of severe injuries received in a car accident. The debtor in a 2011 Chapter 7 case, however, withdrew her adversary proceeding to discharge \$15,000 in private student loan debt upon after a settlement with the creditor to pay most of her debt. In the Chapter 13 case, the debtor listed a student loan claim of \$47,890 on Schedule F, but asserted in his adversary proceeding that his signature on the loan was a forgery and that had been unaware of it until the debtor defaulted and the creditor sought to collect against him. The court ultimately entered an order that the debt not be excepted from discharge, and the debt was discharged.

Even in seemingly plausible cases the debtors did not attempt to have the debt discharged. In one case for example, married debtors had an income consisting of the husband's modest salary as a pressman which put them below the state median income. With expenses, including student loan payments of \$218 per month, the debtors showed negative monthly income of \$267.26 per month. They live in a home valued at \$149,000 against which there are two mortgages, the second one being mostly unsecured. Yet their combined education debt is

\$71,000, with an additional \$25,000 of general unsecured debt. The debtors clearly cannot afford to repay the student loan debt, yet they elected not to attempt to discharge the debt. A number of the cases I reviewed showed debtors with high five-figure or six-figure student loan debt and modest income, but they did not attempt to have the debt discharge. It seems likely that at least some of these debtors will never be able to pay their student debt, but seemingly the “undue hardship” standard is out of reach for them.

My own research and other recent students confirm that nearly half of debtors who filed an adversary proceeding for an undue hardship discharge were successful in obtaining some relief.² Furthermore, debtors who did obtain a student loan debt discharge were likely to have a medical problem or a dependant with a medical problem, be unemployed, and have nominal or no income in the year prior to filing bankruptcy.

B. Profiles of Individual Student Loan Debtors

There are numerous online sites where commentators and student debtors chronicle their experiences.³ The poster-child for crushing student loan debt may be a family practitioner in Columbus, Ohio, whose \$250,000 in loans for medical school eventually mushroomed to \$550,000 after deferments for her residency, missed payments with late fees, and compounding interest.⁴ A more typical situation is a student who borrowed \$79,000 in loans to study interior design at a for-profit college.⁵ By graduation, her debt had grown to over \$100,000. She could not find a job in her field and obtained several forbearances, incurring additional interest and fees. She eventually landed a job in a different field and after making timely payments for five years, she still owes \$98,000. When the loans are paid in 25 years, she will have paid \$211,000. She figures that for now she cannot afford to study for a business degree, start her own business, own a house, or have children. Excessive student debt is even a factor in who people will date or marry.⁶ I’ve have interviewed a number of student loan debtors. Here are a few stories:

² Rafael I. Pardo and Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Education Debt*, 74. U. of Cinn. L. Rev. 405. (Winter 2005); Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Bankruptcy Undue Hardship Standard* (2011) Electronic copy available at: <http://ssrn.com/abstracts=1894445>.

³ See, e.g., Janet Lorin *Indentured Students Rise As Loans Corrode College Ticket*, Bloomberg.com, July 9, 2012, available at <http://www.bloomberg.com/news/2012-07-09/indentured-students-rise-as-loans-corrode-college-ticket.html>. (accessed July 12, 2012)). The author relates how a mother in the 1960s incurred \$5000 in debt for her nursing degree, which she paid off within three years after graduation, while her 38-year old son incurred \$85,000 in debt for a master’s degree, can’t find work, and lives at home. See also, Andrew Martin and Ander W. Lehren, *Degrees of Debt: A Generation Hobbled by the Soaring Cost of College*, New York Times, May 12, 2012, available at <http://www.nytimes.com/2012/05/13/business/student-loans-weighing-down-a-generation-with-heavy-debt.html?pagewanted=all> (accessed May 12, 2013). The article profiles a 2012 graduate of Ohio Northern University works two jobs to pay off \$120,000 loan and lives at home with his parents.

⁴ Mary Pilon, *The \$550,000 Student-Loan Burden*, Wall Street Journal, February 13, 2010, available at <http://online.wsj.com/article/SB10001424052748703389004575033063806327030.html#printMode> (accessed August 17, 2012).

⁵ Sue Shellenbarger, *To Pay Off Loans, Grads Put Off Marriage, Children*, Wall Street Journal, April 17, 2012, available at <http://online.wsj.com/article/SB10001424052702304818404577350030559887086.html> (accessed, April 18, 2012).

⁶ Jennifer Ludden, *Call me Maybe When Your School Loan Is Paid In Full*, NPR, July 16, 2012, available at <http://www.npr.org/2012/07/16/156736915/call-me-maybe-when-your-school-loan-is-paid-in-full> (accessed August 24, 2012).

Chicago Consumer Bankruptcy Conference

1. Debtor 1

Debtor 1 is in her mid-30s and has dual degrees in music education and music therapy from a private non-profit music school, which she attended over 14 semesters from 2003 to 2008. With tuition costs of \$10,000 per semester, living costs of \$13,000 per year, and fees, insurance, instruments, a computer, and other items required by the school, she borrowed \$202,600, including \$138,500 in private loans and \$64,000 in state and federal loans. Debtor 1 had no music training before she enrolled, and no audition was required. Admissions personnel assured her she could readily find contract work in music therapy at \$60 per hour, but no such jobs have ever materialized. And, she cannot work in music education because she cannot afford to perform the four-months of unpaid internship plus purchase the six credits that state licensing would require. Unable to find work in her field after graduation, Debtor 1 is employed as a switchboard operator for a large company where she makes \$29,800 per year. After taxes and modest living expenses, she has \$124 per month for debt service. For years following graduation, she struggled to make loan payments and worked with her lenders to restructure payments. Finally, after going into default on her private loans and with judgments looming, she filed Chapter 13 bankruptcy in 2011. As of the petition date, with interest the debt had mushroomed to \$248,600. During her bankruptcy she will not be making regular loan payments, so interest on the debt will continue to accumulate.

When asked about how she could have allowed so much debt to accumulate, Debtor 1 has several answers. First, coming from a blue-collar background, she knew essentially nothing about finances, making a living, and paying back debt. Higher education was perceived as the key to a meaningful career and lifetime earning potential. It did not occur to her to consider the amount of debt she was accumulating until she was several years into her program, and by then, with so much invested, it was unthinkable not to continue. Second, borrowing, especially from private sources, was absurdly easy. Two loan sources, Citibank and TERI, supplied all of her private loans, and it took only ten minutes online per semester to borrow anywhere from \$10 to \$20 thousand. She was not even required to provide her real signature. One lender required a parent to co-sign each loan, but after obtaining an initial electronic signature from her father, the lender did nothing to verify that the parent had, in fact, agreed to co-sign subsequent loans. It was only after Debtor 1 defaulted that the father who had electronically co-signed one loan learned about the other loans for which he was obligated. Tragically, her father has not communicated with her since that time.

Debtor 1 compartmentalizes the fact that she owes so much, and while she imagines that she will one day be out of debt, there seems to be no feasible way this will ever happen. In the meantime, she has friends, a pet, and a very modest social life. She does not own a home or a car, nor does she have credit cards. She does not expect her situation to change to any time in the foreseeable future.

2. Debtor 2

Debtor 2 is in her mid-30s and has three children under the age of 15. Her annual income of \$30,700 comes from social security disability, child support, and food stamps, and is well

below the state minimum where she lives. Her rental payment of \$550 a month is half the IRS average for a family of four in her area, and all her other allowable expenses (food, clothing, medical, utilities, etc.) are at or below the IRS guidelines. Nevertheless, Debtor 2's allowed expenses of \$2,565 per month exceed her monthly income by \$2.00. Additionally, two of her children have special medical conditions that require frequent hospitalization, and Debtor 2 must care for them around the clock.

Debtor 2 enrolled in a medical training program, but was unable to complete it because of parenting demands. Unfortunately, she borrowed \$17,200 in student loans when she was in the program. With expenses in excess of her social security income, Debtor 2 is unable to pay any of her debt. When she filed for bankruptcy, she also filed an adversary proceeding to have the student loan debt discharged. The creditor answered the complaint and started discovery, including a deposition and interrogatories and requests for production of documents. Among the information requested were documents regarding her medical condition and that of her children. Debtor 2 could not afford the cost to copy all the records, and through her lawyer, offered to provide authorization for the creditor to obtain its own copies. At the conclusion of her deposition, counsel for the creditor told Debtor 2's attorney that as it appeared that she was disabled and unable to pay the debt, he would recommend that his client agree to the discharge and therefore it was not necessary for Debtor 2 to provide any documents or even to proceed with administrative remedies such as income contingent repayment. However, the creditor later refused to agree to the discharge, in part because Debtor 2 had failed to provide documents to establish her medical condition. Ultimately, Debtor 2 entered into an income based repayment program. Based on her income, her payments are \$0, so the result might seem the same as discharge of the debt. However, under IBR, Debtor 2 must provide extensive medical and financial information to prove her condition each year. For her it would have been far easier and less stressful for her if the creditor had agreed to the discharge.

3. Debtor 3

Debtor 3 is in her late 40s and lives in a modest condominium in a Midwestern city. She received a BFA degree at a prestigious university in 1989, for which she incurred a loan for \$11,000 from the Department of Education. In addition, she used credit cards to supplement college costs, and, as she says, "to have a bit of fun during the summers." Debtor 3's first job after college was working in a diner, but eventually she found work in electronic printing. Still, the salary was low and she did not make many payments on her loan. Financially strapped with student loans and credit card debt, Debtor 3 filed a pro se bankruptcy in 1990. She received a discharge in 1991. Debtor 3 says that the standard discharge order was confusing, so she wrote to the judge to confirm that all claims on the list of creditors had been discharged. He returned a handwritten response at the bottom of her letter that said simply "your case was granted," which she took to mean in the debts had been discharged.

Following the bankruptcy, and assuming that her student loan debt had been discharged, and Debtor 3 made no further payments. She even got all references to the loan removed from her credit report, which to her confirmed that the debt was discharged. Nevertheless, student loan collectors continued to call and send collection letters. Sometimes Debtor 3 responded with snarky letters of her own, but she continued to assume that the debt had been discharged.

Chicago Consumer Bankruptcy Conference

However, in 1998 the Department of Education levied on her tax return, and it has continued to do so ever since. A collection agency began pursuing her in earnest starting in 2006, eventually garnishing her wages. For a time, the Department of Education granted her requests for a hardship deferral, but after two years refused to allow any further deferment. Along the way, Debtor 3 studied for and received an MFA in the hopes that it would improve her career prospects. That resulted in an additional \$5,000 student loan owed to a private lender, but the new degree did not enhance her career prospects.

In recent years Debtor 3 has taught part-time and worked in a variety of temporary jobs, but has been unable to find permanent work. She earns sporadic income from process serving, selling art, and even paid medical testing. Debtor 3 has also used credit cards to purchase basic necessities. When her unemployment benefits ran out in 2011, Debtor 3 filed a second pro se Chapter 7. By that time, her federal student loan debt had grown to \$25,000, and she still owed \$2,000 in private student debt. She filed a pro se adversary proceeding against both lenders seeking discharge for undue hardship under the *Brunner* criteria. The private lender did not respond, so the court granted default judgment. This is not a surprising, given that the cost of retaining counsel and responding to the complaint would cost more than the amount owed. But the Department of Education has respond to Debtor 3's complaint, discovery is on-going.

4. Debtor 4

Debtor 4 is a recent law school graduate. Unlike the other debtors profiled above, he has not filed bankruptcy and does not anticipate doing so. But his story is typical of tens of thousands of recent law grads, so it is worthwhile presenting it here. Debtor 4 had no undergraduate student debt and worked at a steady job in business making \$50,000 per year for five years before starting law school. He was not dissatisfied with that income, but was bored and felt his upside prospects were limited, so he decided to attend law school. To pay for law school, Debtor 4 incurred between \$189,000 and \$191,000 in debt (he is not certain of the exact amount). He received two loans each year during law school: a Grad Plus loan of \$40,000 per year that went directly to the law school, and a Stafford loan of \$21,000 per year, which covered his living and other expenses. The amount of his debt is so large that it feels amorphous and almost unreal. He currently has a deferment, but Debtor 4 calculates that when it runs out his payments will be \$1,200 to \$1,500 per month. Right now, however, he is just worried about paying rent and other basic expenses. Despite solid grades in law school, works two temporary legal jobs netting \$2,000 per month. Debtor 4 will take a permanent position wherever he can get it. When asked if he is glad he went to law school, Debtor 4 says yes, but that he is "one of the few who is." Notwithstanding his financial worries, Debtor 4 enjoys legal studies and law work, and is confident that his training and abilities portend a bright future.

**Anatomy of an Adversary Proceeding Initiated by a Debtor Under
Section 523(a)(8) of the Bankruptcy Code**

By: Mark E. Shure

Many student loan borrowers have heard that you “cannot” discharge student loans by filing a bankruptcy petition. Like so many generalized statements of the law, this statement has a basis, yet is far from accurate. Student loans are dischargeable in bankruptcy, but only in limited cases, and only after the debtor initiates and prevails in an adversary proceeding against his or her student loan creditors. Such an action is brought by the debtor under Section 523(a)(8) of the Bankruptcy Code, which states:

§523. Exceptions to discharge. (a) A discharge under section 727, 1141, 1228(a) 1228(b), or 1328(b) of this title does not discharge an individual debtor from any debt:...

(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 (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or (B) any other educational loan that is qualified education loan as defined in section 221(d) (1) of the Internal Revenue Code of 1986, incurred by debtor who is an individual.

This is a brief outline addressing proceedings initiated under Section 523(a)(8).

A. Are the Loans at Issue Governed by Section 523(a)(8)?

The first question which must be addressed by a debtor is whether the loan(s) at issue fall into the Section 523(a)(8) definitions. Virtually all federal student loans would fall into Section 523(a)(8)(A), and certain private loans may also qualify under that section if they are made under a program “funded in whole or part by a non-profit institution”. However, while most private student loans would fall under the provisions of 523(a)(8)(B), certain private loans may not meet that standard because they may not constitute a “qualified education loan” as defined in section

Chicago Consumer Bankruptcy Conference

221(d)(1) of the Internal Revenue Code of 1986. Under that statute, qualifying loans must be used to pay “qualified higher education expenses” which are attributable to “education furnished during a period during which the recipient was an eligible student.” “Qualified higher education expenses” means the “cost of attendance” at an “eligible educational institution”. Because most loans we colloquially refer to as “student loans” meet this definition, whether or not any given loan meets this definition is outside the scope of this brief outline. Nonetheless, this is an issue that is coming up more often with the various types of loans which are now available to student borrowers. In cases of doubt, the debtor may add a declaratory count to an adversary proceeding in order to get a determination as to whether the loans are governed by Section 523(a)(8). If they are not, then the loans would be discharged at the conclusion of the bankruptcy proceeding like any other debt that is not excepted from discharge.

B. Who is the Creditor?

Exactly who is the “student loan creditor” is not always clear to a debtor at the outset of an adversary proceeding. Student loans are often made by a lender who transfers the loan to another entity for servicing, and upon the bankruptcy filing that loan may well be transferred to yet another entity, such as a guaranty agency. Guaranty agencies are governmental or not for profit entities which guarantee loans made by private lenders. Often, a debtor will initiate the adversary proceeding against the entity which has been sending the debtor notices regarding the loan, only to have another entity actually appear, move to intervene, and defend the case.

For example, Educational Credit Management Corp. (“ECMC”) is a guaranty agency located near St. Paul, MN which receives transfers of student loan from other guaranty agencies and the U.S. Department of Education following the institution of a Chapter 13 bankruptcy proceeding. In the event the Chapter 13 debtor subsequently files an adversary proceeding

seeking a discharge of his or her student loans, that proceeding would be defended by ECMC, even if the debtor sued a former holder of the loan. As noted above, even if the debtor brings the suit against an entity that is no longer holding the loan, the entity who is named will typically advise the current holder about the case and that holder will then appear, intervene, and defend the action.

In many student loan cases there are multiple defendants, because many debtors have taken out several student loans over a period of many years, and they seek a discharge of all of them in a single adversary proceeding. Some of those loans may have been made under the Federal Family Education Loan Program and held by one or more guaranty agencies, some may have been made under the Direct Loan Program and held by the U.S. Department of Education, and some may have been made under the private lender loan programs and held by the entities participating in that given program. All such parties may be defendants in a given adversary proceeding if a debtor is seeking a discharge of multiple loans.

C. The Two Tests for Determining Whether a Loan is Dischargeable.

There is no definition of “undue hardship” in the Bankruptcy Code itself. As a result, the bankruptcy courts have established their own framework for analyzing such claims.

By far the most common analysis used is one that was articulated twenty-five years ago by the U.S. Court of Appeals for the Second Circuit in *Brunner v. New York Higher Education Services Corp.*, 831 F. 2d 395 (2d Cir. 1987) (per curiam) (hereinafter “the *Brunner* test”). The *Brunner* test has been adopted by eight other federal circuits, including the Seventh Circuit. *See, In re Roberson*, 999 F.2d 1132, 1135 (7th Cir. 1993) (adopting the *Brunner* test). In addition to the Second and Seventh Circuits, the *Brunner* test has also been adopted in the Third, Fourth, Fifth, Sixth, Tenth and Eleventh Circuits.

Chicago Consumer Bankruptcy Conference

The Eighth Circuit uses a slightly different approach, which it calls the “totality of circumstances test,” which was endorsed by the Eighth Circuit in the case of *Long v. Education Credit Management Corp.*, 322 F.3d 549, 554 (8th Cir. 2003). That test has also been used by some courts in the First Circuit, although the First Circuit Court of Appeals has not formally adopted either test. *Nash v. Conn. Student Loan Fundation*, 446 F.3d 188, 190 (1st Cir. 2006). Each of those tests will be discussed below.

1. The Brunner Test

The *Brunner* test requires the debtor to prove each of the following factors by a preponderance of the evidence, and if the debtor fails to establish any of them, the debtor has failed to meet his or her burden and the loans are not discharged:

- (1) He cannot maintain, based on current income and expenses, a “minimal” standard of living for himself and his dependents if forced to repay the loans;
- (2) 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) He has made good faith efforts to repay the loans.

Goulet v. Educ. Credit Management Corp., 284 F. 3d 773, 777 (7th Cir. 2003)

Each of foregoing factors is analyzed separately by the courts.

a. **Current Income and Expenses and “Minimal Standard of Living”**

This first prong of the *Brunner* test requires an examination of debtor’s current financial condition. The debtor must show that having to repay the loans would cause the standard of living of the debtor and his or her dependents to fall below a “minimal” lifestyle. *In re Roberson*, 999 F. 2d at 1135. This is a tough standard for the debtor, because “minimal” does

not mean comfortable, or even average. In fact, in addressing what is a “minimal” standard of living, many courts start by looking at the federal poverty guidelines. *See, e.g., O’Hearn v. Educ. Credit Mgmt. Corp.*, 339 F.3d 559, 564 (7th Cir. 2003) (in addressing this prong, Seventh Circuit compared debtor’s income to poverty guidelines).

Often, Courts will look to the combined income of all the family members to analyze this factor, even non-debtors, because that income may still be relevant to establishing the debtor’s lifestyle. *See, e.g., In re Pobiner*, 309 B.R. 405, 416 (Banker. E.D. N.Y. 2004) (“The income of a non-debtor spouse is properly considered...”) And in addressing this prong, courts routinely disregard expenses that are not necessary to maintain a “minimal standard of living,” such as club memberships, cell phones, internet and satellite TV. *See, e.g., Educational Credit Management Corp. v. Mosko*, 515 F. 3d 319, 325 (4th Cir. 2008); *Miller v. Pennsylvania Higher Educ. Assistance Agency*, 377 F.3d 616, 623 (6th Cir. 2004).

b. Additional Circumstances Exist Indicating Current Circumstances Will Persist

The debtor must not only establish that his or her current expenses and income are insufficient to maintain a minimal standard of living if required to repay the loan, but the debtor must also show that those circumstances are likely to persist for a significant portion of the repayment period. As the Seventh Circuit has stated, a student loan discharge should be based “on certainty of hopelessness, not simply a present inability to meet a financial commitment.” *In re Roberson*, 999 F.2d at 1135-36.

Current unemployment is typically not enough, since that is not a permanent condition. Rather, there must be additional factors which suggest that the current situation, such as unemployment, is likely to persist. Courts have looked to such factors as the mental or physical disabilities of debtor and his or her dependants, lack of meaningful education or job skills, the

Chicago Consumer Bankruptcy Conference

debtors' obligation to care for dependents, the debtor's age, and any other facts that might prevent retraining or relocation. *Educational Credit Management Corp. v. Nys*, 446 F.3d 938, 946 (9th Cir. 2006). The burden remains on the debtor "to prove that he cannot earn more money in the years to come..."*In re Mallinckrodt*, 274 B.R. 560, 567 (S.D. FL 2002).

c. Good Faith Effort to Repay

The debtor must also show that he or she has made a good faith effort to repay the loan. Good faith efforts are typically measured by showing efforts to obtain employment, maximize income, and minimize expenses, and the debtor should also show that his or her condition results from factors beyond his or her reasonable control. *In re Roberson*, 999 F. 2d at 1136. In addition, whether the debtor has made consistent, voluntary payments when able to do so is also relevant to this factor. *Goulet v. Educ. Credit. Management Corp.*, 284 F.3d 773, 776 (7th Cir. 2003)..

2. Totality of Circumstances Test

Under this test a bankruptcy court should "consider the debtor's reasonably reliable future financial resources, his reasonably necessary living expenses, and any other relevant facts" in determining whether an undue hardship exists in that particular case. *Long v. Educ. Credit Mgmt. Corp.*, 322 F.3d 549, 554 (8th Circ. 2003). This test is more flexible than the *Brunner* test in that it allows bankruptcy courts more latitude in determining what circumstances meet the standard of "undue hardship". A major difference between the two tests is that the "totality of circumstances" test does not require a debtor to establish that he or she has made good faith efforts to repay the loan. *In re Nash* 446 F. 3d, 188, 190 (1st Cir. 2006).

D. Litigating a Student Loan "Undue Hardship" Case

American Bankruptcy Institute

In any case initiated to determine “undue hardship”, the debtor and debtor’s counsel should not initiate the action unless they are fully prepared to go through trial, and possibly also an appeal. Because rulings can impact future cases, many student loan creditors tend to litigate these cases vigorously. Creditors will often not even discuss settlement until after full discovery is completed, and even then they will not agree to a discharge of the loans in the absence of compelling facts. With the state of the law in this area, student loan creditors are typically very willing to require a debtor to try their case, and if the result is adverse to the creditor, the creditor may very well appeal.

This is not to say debtors always lose these cases. In fact, a detailed study of student loan discharge cases was conducted by two professors, Rafael Pardo and Michelle Lacey, and their findings were published in their article, *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 Am Bankr.L.J. 179 (2009). This study looked at every undue hardship case initiated in the Western District of Washington over the five year period from 2002 through 2006. This study found that approximately 57% of those cases resulted in an undue hardship discharge. What is striking is that an average of only 27 cases per year were filed in that entire judicial district, even though there were over 8,000 non-business bankruptcies filed in that district in 2006 alone. That shows that in all likelihood, a large number of student loan debtors did not even take on the burden of trying to prevail in an undue hardship case. This study also examined the facts at issue in 46 undue hardship cases and found that even though the average debtor in those cases was “in horrible financial shape” with debt to income ratio far exceeding the debt to income ratios of most debtors, 26% of those cases still went to trial. This fact shows the reluctance of creditors to settle these cases and highlights the fact that debtors have to be prepared to litigate these cases through trial once they are filed.

CONCLUSION

Whether viewed under the *Brunner* test or the “totality of circumstances test,” obtaining a discharge of Student loan indebtedness under Section 523(a)(8) of the Bankruptcy Code is difficult, but not impossible. However, under either standard the debtor must take the initiative by initiating the adversary proceedings and the debtor will have to establish the relevant factors by preponderance of evidence. Consequently, unless a debtor has a significant chance of establishing the necessary factors, initiating an undue hardship adversary proceeding might not be worth the time, cost and effort to the debtor.

Adjusting Student Loan Debt Outside of Section 523(a)(8)

By: Prof. Susan E. Hauser⁷

As discussed above, student loans - both public and private - are presently nondischargeable under § 523(a)(8) unless the debtor can prove undue hardship. The current law is the product of a series of increasingly stringent amendments to the Bankruptcy Code that roughly parallels the development of the modern student loan industry.⁸ These amendments have made § 523(a)(8) increasingly creditor-friendly, culminating with a 2005 amendment added by BAPCPA extending nondischargeability to student loans made by private lenders.

The enormous expansion in the amount of student loan debt has, at the same time, presented bankruptcy lawyers and judges with individual debtors who are genuinely unable to repay the full amount of their educational debt.⁹ The tension between the restrictive language of the Code and the reality of their caseload has created pressure on both judges and lawyers to push the law in new directions to allow relief to overburdened debtors. This section examines the resulting cases, dividing them into the following categories: (1) partial discharge of

⁷ Robert N. Zinman Scholar in Residence, American Bankruptcy Institute; Associate Professor, North Carolina Central University School of Law

⁸ 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 the date 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)). Student loans made by private lenders, as opposed to governmental units or nonprofit institutions, were made nondischargeable by BAPCPA in 2005.

⁹ *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.

Chicago Consumer Bankruptcy Conference

educational debt, (2) separate classification of student loan debt in chapter 13 plans, and (3) the possibility of using plan confirmation to obtain a discharge “by declaration.”

A. Partial Discharge

A number of courts have been willing to discharge part of a debtor’s student loan obligations when the facts do not support a finding that the entire obligation poses an undue hardship on the debtor. These cases are fact-driven. As the Sixth Circuit explained in *Hornsby v. Tennessee Student Assistance Corp. (In re Hornsby)*, a partial discharge of student loan debt may be appropriate “where facts and circumstances require intervention in the financial burden on the debtor, [and] an all-or-nothing treatment thwarts the purpose of the Bankruptcy Act.”¹⁰

Hornsby was the first circuit court decision upholding the bankruptcy courts’ equitable power to grant a partial discharge of student loan debt under § 105(a)’s authority to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.”¹¹ *Hornsby*, however, did not squarely address the relationship between § 105(a) and § 523(a)(8). The Sixth Circuit revisited this issue in *Miller v. Pennsylvania Higher Education Assistance Agency (In re Miller)*, clarifying that § 105(a) provides no “independent rubric” and must be read in conjunction with § 523(a)(8) to evaluate when a partial discharge is appropriate.¹²

A similar approach has been adopted in the Ninth, Tenth, and Eleventh Circuit Courts of Appeal.¹³ While recognizing that the bankruptcy court’s equitable powers do not allow it to

¹⁰ 144 F.3d 433, 439 (6th Cir. 1998).

¹¹ 11 U.S.C. § 105(a). A number of bankruptcy courts had previously used § 105(a) to grant a partial discharge of student loan debt – sometimes with no reference to § 523(a)(8). See, e.g., *Griffin v. Eduserv (In re Griffin)*, 197 B.R. 144 (Bankr. E.D. Okla. 1996) (relying on § 523(a)(8)); *In re Brown*, 18 B.R. 219 (Bankr. D. Kan. 1982) (no reference to § 523(a)(8)); *In re Albert*, 25 B.R. 98 (Bankr. D. Ohio 1982) (no reference to § 523(a)(8)).

¹² 377 F.3d 616, 622 (6th Cir. 2004).

¹³ *Saxman v. Educational Credit Management Corp. (In re Saxman)*, 325 F.3d 1168 (9th Cir. 2003); *Alderete v. Educational Credit Management Corp. (In re Alderete)*, 412 F.3d 1200 (10th Cir. 2005); *Hemar Ins. Corp. of Am. v. Cox (In re Cox)*, 338 F.3d 1238 (11th Cir. 2003). The Third Circuit reversed the bankruptcy court’s grant of a partial

ignore the specific statutory language found in § 523(a)(8), these four circuits hold that “§ 105(a) authorizes a bankruptcy court to grant a partial discharge where the undue hardship requirement of § 523(a)(8) is met as to part but not all of a student loan.”¹⁴

Under these decisions, the bankruptcy court may not use its equitable powers to grant a partial discharge unless § 523(a)(8) has been satisfied as to some portion of the obligation. “To allow the bankruptcy court, through principles of equity, to grant any more or less than what the clear language of § 523(a)(8) mandates would be tantamount to judicial legislation and is something that should be left to Congress, not the courts.”¹⁵

Lower courts outside these four circuits have been less uniform in their approach, with a number finding that the Code does not permit a partial discharge of student loan debt.¹⁶ Decisions applying this strict approach find that § 105(a) does not authorize the bankruptcy court “to use its equitable powers to achieve a result not contemplated by the Code, particularly where a specific section of the Code squarely addresses the issue before the court.”¹⁷ Other courts have allowed partial discharge without circuit authority, and have generally followed the approach of the circuits, looking to § 105(a) as a source of equitable authority to soften the application of §

discharge in *Faish v. Penn. Higher Educ. Assistance Agency (In re Faish)*, 72 F.3d 298 (3d Cir. 1995), however, it did so on factual grounds without discussion of the related law in an opinion devoted to the adoption of the *Brunner* test.

¹⁴ *Miller*, 377 F.3d at 621, quoting *Nary v. Complete Source (In re Nary)*, 253 B.R. 752, 767 (N.D. Tex. 2000).

¹⁵ *Cox*, 338 F.3d at 1207.

¹⁶ *Pincus v. Graduate Loan Center (In re Pincus)*, 280 B.R. 303 (Bankr. S.D.N.Y. 2002); *Young v. PHEAA (In re Young)*, 225 B.R. 312 (Bankr. E.D. Penn. 1998) (partial discharge sought by creditor to avoid discharge *in toto*); *Skaggs v. Great Lakes Higher Educ. Corp. (In re Skaggs)*, 196 B.R. 865 (Bankr. W.D. Okla. 1996); *Hawkins v. Buena Vista College (In re Hawkins)*, 187 B.R. 294 (Bankr. N.D. Iowa 1995). *And see* *Andreson v. Nebraska Student Loan Program, Inc. (In re Andreson)*, 232 B.R. 127 (8th Cir. B.A.P. 1999) (finding no authority in the Code for partial discharge, but declining to decide the issue).

¹⁷ *Pincus*, *supra* note 9, at 312.

Chicago Consumer Bankruptcy Conference

523(a)(8).¹⁸ A small minority of courts, however, has been willing to draw the power for partial discharge solely from the language of § 523(a)(8).¹⁹

In courts that allow partial discharge, a final issue is the form that the partial discharge will take. When, as is typical, debtors owe more than one student loan, some decisions frame the partial discharge as a complete release from liability on specific loans, while leaving the debtor entirely liable on the remaining loans.²⁰ Some courts have followed this “loan by loan” pattern without regarding this as a partial discharge, holding instead that each loan can be treated as a singular entity.²¹ Other courts reject the loan by loan approach, holding that student loans must be treated in the aggregate.²²

Another set of courts has been willing to grant a partial discharge that is effectively a loan modification. These decisions either reduce the principal balance on the loans to a more manageable amount,²³ relieve the debtor from liability on interest and fees while leaving the debtor liable on the principal,²⁴ impose a deferral,²⁵ or fashion another appropriate equitable

¹⁸ *Stevenson v. Educational Credit Management Corp.* (*In re Stevenson*), 463 B.R. 586 (Bankr. D. Mass. 2011) (looking to § 105(a)); *Fraleigh v. U.S. Dept. of Ed.*, 247 B.R. 417 (Bankr. N.D. Ohio 2000); *Fox v. Student Loan Mktg. Ass’n* (*In re Fox*), 189 B.R. 115 (Bankr. N.D. Ohio 1995).

¹⁹ *See, e.g., Rivers v. United Student Aid Funds, Inc.* (*In re Rivers*), 213 B.R. 616 (Bankr. S.D. Ga. 1997) and cases cited therein.

²⁰ *Hinkle v. Wheaton College* (*In re Hinkle*), 200 B.R. 690 (Bankr. W.D. Wash. 1996); *Coutts v. Mass. Higher Educ. Corp.* (*In re Coutts*), 263 B.R. 394 (Bankr. D. Mass. 2001); *Gharavi v. U.S. Dept. of Educ.* (*In re Gharavi*), 335 B.R. 492 (Bankr. D. Mass. 2006); *Ledbetter v. U.S. Dept. of Ed.* (*In re Ledbetter*), 254 B.R. 714 (Bankr. S.D. Ohio 2000) (following *Andreson, supra* note 9). *Cf. Young, supra* note 9, at 318 (“If a holder of student loans is prepared to stipulate that certain student loans are unconditionally dischargeable, leaving only a limited number of loans remaining as particularly nondischargeable, there would seem to be no way of stopping it from doing so.”)

²¹ *See Andreson, supra* note 9 (although 2 of 3 student loans were discharged, the B.A.P held that this was not a partial discharge because each loan could be treated separately); *Hollister v. University of N.D.*, 247 B.R. 485 (Bankr. W.D. Okla. 2000) (adopting the reasoning of *Andreson*); *Grigas v. Sallie Mae Servicing Corp.* (*In re Grigas*), 252 B.R. 866 (Bankr. D.N.H. 2000).

²² *Pincus, supra* note 9 (rejecting the “loan by loan” approach); *Young, supra* note 9; *Raimondo v. New York State Higher Educ. Serv. Corp.* (*In re Raimondo*), 183 B.R. 677 (Bankr. W.D.N.Y. 1995) (holding that equity requires equal treatment among student lenders).

²³ *Hedlund v. Educational Resources Inst., Inc.* (*In re Hedlund*), 468 B.R. 901 (D. Or. 2012). The bankruptcy court discharged all amounts owed in excess of \$32,080. The district court reversed on the ground that debtor had failed to establish good faith as required by *Brunner and In re Pena*, 155 F.3d 1108 (9th Cir. 1998).

²⁴ *Alderete, supra* note 6; *Griffin v. Eduserv*, 197 B.R. 144 (Bankr. E.D. Okla. 1996).

remedy.²⁶ The variability of the remedy in partial discharge cases illustrates the difficulty that arises when courts fashion equitable amendments to the Code.

B. Separate Classification in Chapter 13

As in chapter 7, student loan debt is generally nondischargeable in chapter 13 cases and does not have priority status.²⁷ Despite this, debtors have sometimes used 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.²⁸

The relevant provisions of the Code for this purpose are §§ 1322(b)(1) and (5).²⁹ 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 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

²⁵ *Cheesman v. Tennessee Student Assistance Corp. (In re Cheesman)*, 25 F.3d 356 (6th Cir. 1994) (student loans nondischargeable, but order stayed for 18 months); *In re Roberson*, 999 F.2d 1132 (7th Cir. 1993) (bankruptcy court’s order deferring student loan payments for 2 years affirmed without discussion); *Dennehy v. Sallie Mae (In re Dennehy)*, 201 B.R. 1008 (Bankr. N.D. Fla. 1996).

²⁶ In *Stevenson*, *supra* note 11, the court granted the debtor a prospective discharge of whatever debt remained at the conclusion of her participation in the Ford Program’s Income Based Repayment Plan.

²⁷ 11 U.S.C. §§ 507 and 1328(a)(2).

²⁸ 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.

²⁹ 11 U.S.C. § 1322(b)(10), a provision added by BAPCPA that limits the payment of interest on nondischargeable unsecured claims in chapter 13, is also a factor in some cases.

Chicago Consumer Bankruptcy Conference

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, however, the issue then becomes whether § 1322(b)(5) controls over the conflicting “unfair discrimination” provision found in § 1322(b)(1).

This problem has been addressed by a number of courts, with a minority of reported decisions finding that subsection (b)(5) trumps (b)(1), thereby completely excepting long-term unsecured debt payments from the unfair discrimination analysis of subsection (b)(1).³⁰ 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).³¹

The Code does not define “unfair discrimination,” and courts have developed several multi-factor tests to enable this analysis. The most widely used test, stated by the Eighth Circuit in *In re Leser*,³² 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.”³³ A variation of the *Leser* test was

³⁰ See, e.g., *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.”)

³¹ See, e.g., *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 Harding*, 423 B.R. 568 (Bankr. S.D. Fla. 2010); *In re Simmons*, 288 B.R. 737 (Bankr. N.D. Tex. 2003).

³² *Mickelson v. Leser (In re Leser)*, 939 F.2d 669 (8th Cir. 1991).

³³ *In re Webb*, 370 B.R. 418, 423 (Bankr. N.D. Ga. 2007).

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.”³⁴

The *Leser* test has been criticized as offering “no real direction for determining the fairness of discrimination in any given instance,”³⁵ and other courts have attempted to develop more concrete alternatives.³⁶ The most prominent of these alternatives is the “baseline” test enunciated by the First Circuit BAP in *In re Bentley*.³⁷ *Bentley* looks to the “principles and structure of Chapter 13” as the “baseline against which to evaluate discriminatory provisions for unfairness.”³⁸ 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 disposable income to the plan, and (4) particular facts may show 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.³⁹ 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.⁴⁰ Some courts have also found

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

³⁵ *Bentley v. Boyajian (In re Bentley)*, 266 B.R. 229 (1st Cir. B.A.P. 2001).

³⁶ *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 opined: “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.”

³⁷ *Supra* note 28.

³⁸ *Id.* at 240.

³⁹ *Groves v. LaBarge (In re Groves)*, 39 F.3d 212 (8th Cir. 1994); *In re Gonzalez*, 206 B.R. 239 (Bankr. S.D. Fla. 1997).

⁴⁰ *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).

Chicago Consumer Bankruptcy Conference

discrimination justifiable by the debtor's strong financial interest; for example, when a debtor not allowed to make direct payments would emerge from chapter 13 owing more on her student loans than she did before the case was filed.⁴¹

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 expenses specified in National and Local Standards issued by the IRS, 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 "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 less than one percent.⁴²

C. United Student Aid Funds, Inc. v. Espinosa: Discharge by Declaration

Espinosa presents one final (albeit improper) strategy for dealing with student loan debt.⁴³ The debtor in *Espinosa* discharged the interest on his student loan debt in a chapter 13 plan without filing an adversary proceeding. Although the creditor had notice of the plan treatment, it did not file an objection to confirmation. The creditor then attempted to collect the interest three years after the debtor's discharge, and the debtor filed a motion asking the

⁴¹ *Webb*, *supra* note 26.

⁴² *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).

⁴³ 130 S. Ct. 1367 (2010).

bankruptcy court to enforce its discharge order. The creditor responded with a cross-motion under Rule 60(b)(4) asking that the court to set aside the confirmation order as void.

In a unanimous opinion, the Supreme Court held that the confirmation order was a final judgment that was not rendered void by the bankruptcy court's "legal error" in discharging a student loan obligation without a finding of undue hardship. The bankruptcy court's error was not jurisdictional and did not violate the creditor's due process rights.⁴⁴ In reaching this holding, the Court stated that the bankruptcy court had an obligation to avoid this type of error by independently determining undue hardship, even without objection or appearance by the creditor. The Court also stressed that the specter of sanctions should deter "bad-faith" practices by debtors and their counsel.

⁴⁴ Section 523(a)(8)'s undue hardship requirement is a statutory precondition to discharge that does not limit the court's jurisdiction. And, despite the absence of a summons and complaint, due process was satisfied by the creditor's actual notice of the contents of the plan.