

Very Good Debates

Mitchell Ryan, Moderator

Rust Omni; Orange, Calif.

Resolved: Success fees for financial advisors should be eliminated.

Candace C. Carlyon

Carlyon & Smith, PLLC; Las Vegas

Frank A. Merola

Stroock & Stroock & Lavan LLP; Los Angeles

Resolved: Claims benefiting from third-party guaranties may be separately classified.

Pro: Hon. Barry Russell

U.S. Bankruptcy Court (C.D. Cal.); Los Angeles

Con: Hon. Eileen W. Hollowell

U.S. Bankruptcy Court (D. Ariz.); Tucson

Resolved: Section 523(a)(8) limiting discharge of student loans should be eliminated.

Pro: Kasey C. Nye

Mesch, Clark & Rothschild, P.C.; Tucson, Ariz.

Con: Madeleine C. Wanslee

Gust Rosenfeld, PLC; Phoenix



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Resolved: Success Fees for Financial Advisors Should be Eliminated

Candace C. Carlyon, Esq.

Las Vegas, NV

Frank Merola, Esq.

Stroock & Stroock & Lavan, LLP

Los Angeles, CA

(Sides to be determined by coin toss.)

Compensation of Financial Consultants

The term “financial consultants” encompasses a wide range of services, which may include assistance with management, valuation, and investment banker services. Financial advisors typically negotiate fee provisions which include a flat monthly payment, and a back end “success” or “transaction” fee. See sample retention agreement attached as exhibit 1. The definition of “success” often includes any new financing, debt restructuring, asset sale, or confirmation. (There have even been attempts to characterize appointment of a trustee, conversion, or dismissal as “transactions” triggering a fee-attempting to include all possible outcomes of a case in order to assure that payment of the back end fee is a certainty. The parties and the courts may be reluctant to approve such payments, particularly as the nexus between the work performed and the achievement of a positive result becomes more tenuous. Inherent in this tension is the distinction between approval of employment and compensation terms under Section 238 vs. 330 of the Bankruptcy Code.

Employment and Compensation Under Section 328

The trustee, or a committee appointed under section 1102 of this title, with the court’s approval, may employ or authorize the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis. Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions.

11 U.S.C. § 328(a)

328(a) is the provision which iterates terms under which a trustee, debtor in possession or committee can employ a professional. It is not itself a separate source of employment approval. If such terms and conditions are not reasonable, the bankruptcy judge may exercise his discretion, and deny the employment under 11 U.S.C. § 1103(a).

Unsecured Creditors' Comm., Houlihan, Lokey, Howard & Zukin Fin. Advisors, Inc. v. Joel Pelofsky, United States Trustee (In re Thermadyne Holdings Corp., et al), 283 B.R. 749, 755 n. 9 (8th Cir. BAP 2002).

Section 328 was added to the Bankruptcy Code in 1978. Prior to 1978, some professionals refused to work for bankruptcy estates because their compensation could potentially be changed by a bankruptcy judge after the professionals had completed the work. *Nat'l Gypsum Co.*, 123 F.3d 861, 862 (5th Cir.1997).

“Once the bankruptcy court has approved a rate or means of payment, such as a contingent fee, the court cannot on the submission of the final fee application instead approve a ‘reasonable’ fee under § 330(a), unless the bankruptcy court finds that the original arrangement was improvident due to unanticipated circumstances as required by § 328(a).” *In re Tex. Sec., Inc.*, 218 F.3d 443, 445–46 (5th Cir.2000) (citing *In re Nat'l Gypsum Co.*, 123 F.3d at 862–63); *XO Commc'ns, Inc.*, 323 B.R. 330, 339 (Bankr.S.D.N.Y.2005) (“Under section 328(a), a [bankruptcy] court may not revisit its prior determination as to the reasonableness of an agreement previously approved unless it determines that the terms and conditions proved to be improvident at the time approved in light of then-unforeseen circumstances.”); *In re High Voltage Eng'g Corp.*, 311 B.R. 320, 332 (Bankr.D.Mass.2004) (“Once a fee arrangement is approved under § 328, the ability of the bankruptcy court, as well as creditors and parties in interest, to review the amount of compensation payable to the professional is circumscribed.”). Section 328(a) requires that subsequent developments rendering the fee arrangement improvident must be unforeseeable, not merely unanticipated, and therefore granting any requested modification to the fee agreement is very unlikely. *See Daniels v. Barron, et al. (In re Barron)*, 325 F.3d 690, 693–94 (5th Cir.2003); *XO Commc'ns, Inc.*, 323 B.R. at 339 (“A finding of improvidence pursuant to section 328 is a difficult determination to make and therefore, courts rarely disturb the original terms and conditions of a professional’s employment.”)

Employment and Compensation Under Section 330

Section 330(a) of the Bankruptcy Code states in pertinent part:

(a)(1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103—

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses.

(2) The court may, on its own motion or on the motion of the United States Trustee, the United States Trustee for the District or Region, the trustee for the estate, or any other party in interest, award compensation that is less than the amount of compensation that is requested.

(3) In determining the amount of reasonable compensation to be awarded to an examiner, trustee under chapter 11, or professional person, the court shall consider the nature, the extent, and the value of such services, taking into account all relevant factors, including—

(A) the time spent on such services;

(B) the rates charged for such services;

(C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;

(D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed;

(E) with respect to a professional person, whether the person is board certified or otherwise has demonstrated skill and experience in the bankruptcy field; and

(F) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

(4)(A) Except as provided in subparagraph (B), the court shall not allow compensation for—

(i) unnecessary duplication of services; or

(ii) services that were not—

(I) reasonably likely to benefit the debtor’s estate; or

(II) necessary to the administration of the case.

To receive compensation under § 330, professionals hired in a bankruptcy case must provide a tangible, identifiable, and material benefit to the estate. *Andrews & Kurth L.L.P. v. Family Snacks, Inc. (In re Pro-Snax Distributors, Inc.)*, 157 F.3d 414 (5th Cir.1998).

§ 330(a) affords bankruptcy courts broad discretion when determining the amount that professionals should be paid after they have completed their engagements. *See In re Babcock & Wilcox Co.*, 526 F.3d 824, 828 (5th Cir.2008). This discretion enables bankruptcy courts to consider numerous factors—including (1) the lodestar, (2) those found in § 330(a)(3)’s non-exclusive list, and (3) those listed in *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714, 717–19 (5th Cir.1974)—when determining “reasonable compensation.” *Pilgrim’s Pride*, 690 F.3d at 654–56.

In the Matter of ASARCO, L.L.C., 702 F.3d 250, 260-61 (5th Cir. 2012).

“Success Fees”

Under the agreements reached by the financial advisors with their clients, each financial advisor was entitled to a monthly fee (which has been paid on a regular basis) as well as expenses. Each financial advisor also negotiated a “success fee,” to be paid in the event of a successful end to the Debtors’ cases. Not surprisingly, “success” (usually referred to by the Applicant as “restructuring” or a “transaction”) is defined broadly by the financial advisors. Only by implication is there any intent to tie a successful result in the case to the financial advisor’s work, and in the case at bar, in which liquidation in chapter 7 was not a realistic possibility, some sort of “success” was inevitable. As counsel for Houlihan advised the court during the Hearing, even had his client done no work whatsoever to earn its fees, it would be entitled to the success fee for which it negotiated.

...

many financial advisors insist in a chapter 11 case on tying their compensation to a “successful” outcome of the case. This, in turn, suggests that the efforts of a financial advisor should be measured, if not in lodestar fashion, then by the contributions of the advisor to the successful outcome of the case. Logically, this means a financial advisor’s compensation should be based on the advisor’s part in bringing about a successful * result. Certainly in the case at bar this court cannot find that the Debtors’ estate and its constituencies received direct benefit commensurate with the fees now to be paid to some of the financial advisors.

In re Mirant Corporation, 354 B.R. 113, 127-28 (Bankr. N.D. Tex. 2006)

Exhibit 1

As of May 1, 2008

Robert Y. Brown, III
President
Tronox Worldwide LLC
One Leadership Square
Suite 300 211 N. Robinson Ave.
Oklahoma City, Oklahoma 73102

Dear Mr. Brown:

This letter (the "Agreement") will confirm the terms and conditions of the agreement among Tronox Worldwide LLC (collectively with its parent, direct and indirect subsidiaries, the "Company") and Rothschild Inc. ("Rothschild") regarding the retention of Rothschild as financial advisor and investment banker to the Company in connection with a possible restructuring of its businesses and/or certain liabilities of the Company.

Section 1 Services to be Rendered In connection with the formulation, analysis and implementation of various options for a restructuring, reorganization or other strategic alternative relating to the Company, whether pursuant to a Transaction (as defined below) or any series or combination of Transactions, Rothschild will perform the following services as necessary and requested by the Company:

- (a) to the extent deemed desirable by the Company, identify and/or initiate potential Transactions;
- (b) to the extent Rothschild deems necessary, appropriate and feasible, or as the Company may request, review and analyze the Company's assets and the operating and financial strategies of the Company;
- (c) review and analyze the business plans and financial projections prepared by the Company including, but not limited to, testing assumptions and comparing those assumptions to historical Company and industry trends;
- (d) evaluate the Company's debt capacity in light of its projected cash flows and assist in the determination of an appropriate capital structure for the Company;
- (e) assist the Company and its other professionals in reviewing the terms of any proposed Transaction or other transaction, in responding thereto and, if directed, in

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212 457 2572

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Email todd.snyder@us.rothschild.com

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evaluating alternative proposals for a Transaction;

(f) determine a range of values for the Company and any securities that the Company offers or proposes to offer in connection with a Transaction;

(g) advise the Company on the risks and benefits of considering a Transaction with respect to the Company's intermediate and long-term business prospects and strategic alternatives to maximize the business enterprise value of the Company;

(h) review and analyze any proposals the Company receives from third parties in connection with a Transaction or other transaction, including, without limitation, any proposals for debtor-in-possession financing, as appropriate;

(i) assist or participate in negotiations with the parties in interest, including, without limitation the former parent of Tronox and its successor entities, any appropriate regulatory agencies, any current or prospective creditors of, holders of equity in, or claimants against the Company and/or their respective representatives in connection with a Transaction;

(j) advise the Company with respect to, and attend, meetings of the Company's Board of Directors, creditor groups, official constituencies and other interested parties, as necessary;

(k) in the event the Company determines to commence Chapter 11 cases, and if requested by the Company, participate in hearings before the Bankruptcy Court in which such cases are commenced (the "Bankruptcy Court") and provide relevant testimony with respect to the matters described herein and issues arising in connection with any proposed Plan (as defined below);

(l) render such other financial advisory and investment banking services as may be agreed upon by Rothschild and the Company.

As used herein, the term "Transaction" shall mean, collectively, whether pursuant to a plan of reorganization (a "Plan") confirmed in connection with any case or cases commenced by or against the Company, any of its subsidiaries, any of its affiliates or any combination thereof, whether individually or on a consolidated basis (a "Bankruptcy Case"), under Title 11 of the United States Code §§ 101 *et seq.* (the "Bankruptcy Code") or otherwise; (a) any transaction or series of transactions that affects or proposes to affect material amendments to or other material changes in any of the Company's outstanding

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indebtedness (both on and off balance sheet), trade claims, leases (both on and off balance sheet), environmental and other legacy liabilities, litigation-related liabilities, preferred equity, and other liabilities including, without limitation, any exchange or repurchase of a material amount of the Company's indebtedness; (b) pursuant to §363 of the Bankruptcy Code or otherwise (i) any merger, consolidation, reorganization, recapitalization, financing, refinancing, business combination or other transaction pursuant to which the Company (or control thereof) is acquired by, or combined with, any person, group of persons, partnership, corporation or other entity (an "Acquirer") or (ii) any acquisition, directly or indirectly, by an Acquirer (or by one or more persons acting together with an Acquirer pursuant to a written agreement or otherwise), whether in a single transaction, multiple transactions or a series of transactions, of (x) other than in the ordinary course of business, any material portion of the assets or operations of the Company or (y) any outstanding or newly-issued shares of the Company's capital stock or any securities convertible into, or options, warrants or other rights to acquire such capital stock or other equity securities of the Company, for the purpose of effecting a recapitalization or change of control of the Company; (c) any restructuring, reorganization, exchange offer, tender offer, refinancing or similar transaction, whether or not pursuant to a Plan; or (d) any transaction similar to any of the foregoing. Notwithstanding any other provision of this Agreement, the term "Transaction" as used herein shall include any transaction described above in which consideration includes a credit or other bid involving consideration other than cash, in whole or in part, such as pre- and post-petition loans, trade claims, leases, other outstanding pre- and post-petition indebtedness or other non-cash consideration. For the avoidance of doubt, a disposition of Tronox GmbH shall not constitute a "Transaction."

In performing its services pursuant to this Agreement, and notwithstanding anything to the contrary herein, Rothschild is not assuming any responsibility for the Company's decision to pursue (or not to pursue) any business strategy or to effect (or not to effect) any Transaction or other transaction. Rothschild shall not have any obligation or responsibility to provide accounting, audit, "crisis management" or business consultant services to the Company, and shall have no responsibility for designing or implementing operating, organizational, administrative, cash management or liquidity improvements. The parties hereto acknowledge that (a) the Company is a party to an agreement with Lehman Brothers, dated as of June 12, 2007 (the "Lehman Agreement"), (b) Rothschild has been provided a copy of the Lehman Agreement, and (c) the services to be provided by Rothschild hereunder shall not include services in connection with a "Sale" (as defined in the Lehman Agreement).

Section 2 Information Provided by the Company.

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(a) The Company will cooperate with Rothschild and furnish to, or cause to be furnished to, Rothschild any and all information available to the Company and as Rothschild deems reasonably appropriate to enable Rothschild to render services hereunder (all such information being the "Information"). The Company recognizes and confirms that Rothschild (i) will use and rely solely on the Information and on information available from generally recognized public sources in performing the services contemplated by this Agreement without having assumed any obligation to verify independently the same; (ii) does not assume responsibility for the accuracy or completeness of the Information and such other information, and (iii) will not act in the official capacity of an appraiser of specific assets of the Company or any other party. The Company confirms that the information to be furnished by the Company, when delivered, to the best of its knowledge will be true and correct in all material respects, will be prepared in good faith, and will not contain any material misstatement of fact or omit to state any material fact. The Company will promptly notify Rothschild if it learns of any material inaccuracy or misstatement in, or material omission from, any Information theretofore delivered to Rothschild. The Company acknowledges that in the course of this engagement it may be necessary for Rothschild and the Company to communicate electronically.

(b) Each party further acknowledges that although it will use commercially reasonable procedures to check for the most commonly known viruses, the electronic transmission of information cannot be guaranteed to be secure or error-free. Furthermore such information could be intercepted, corrupted, lost, destroyed, arrive late or incomplete or otherwise be adversely affected or unsafe to use. Accordingly, the parties agree that neither party shall have any liability to the other with respect to any error or omission arising from or in connection with: (i) the electronic communication of information to the other party; or (ii) the receiving party's reliance on such information.

(c) As used herein, the term "Confidential Information" shall mean all Information provided to Rothschild by the Company other than information which (i) has become part of the public domain other than by acts or omissions of Rothschild or its employees or (ii) becomes available to Rothschild on a non-confidential basis from a source other than the Company, provided that source is not bound by a confidentiality agreement with the Company or otherwise prohibited from transmitting the information to Rothschild by a contractual, legal or fiduciary obligation; (iii) was in Rothschild's possession prior to disclosure by the Company and was not acquired by Rothschild, its employees or representatives directly or, to Rothschild's knowledge, indirectly from the Company. Except as required by applicable law or judicial, regulatory or legal process, Rothschild shall keep confidential (with the same level of care Rothschild uses with its

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own confidential business information) all Confidential Information, and shall not disclose such Confidential Information to any third party except to those persons who need to know such information in connection with Rothschild's performance of its responsibilities hereunder, including but not limited to its employees or advisors, and who are advised of the confidential nature of the Confidential Information and who agree to keep such information confidential. Rothschild agrees that the Confidential Information shall not be used for any purpose other than Rothschild's engagement under this Agreement. If Confidential Information is requested from Rothschild as a result of legal or administrative process, Rothschild shall use commercially reasonable efforts to give the Company prompt written notice of such circumstance.

(d) In the event that any Confidential Information is stored electronically on Rothschild's computers systems, Rothschild shall not be liable for any damages resulting from unauthorized access, misuse or alteration of such information by persons of such information provided Rothschild takes commercially reasonable steps to prevent such access. All confidential information, including such information stored electronically on Rothschild's computer systems, shall be the sole and exclusive property of the Company. Upon termination of this Agreement, upon request, Rothschild shall return or destroy all copies of the Confidential Information, including Confidential Information stored electronically on Rothschild's computer systems; provided, however, that Rothschild shall be entitled to retain (i) copies of all Confidential Information to be retained in Rothschild's records management or legal department for record and archive purposes only, and (ii) Confidential Information Rothschild is required to retain in order to satisfy the requirements of any law, regulation or securities exchange rule applicable to Rothschild, in each case subject to the confidentiality provision contained in this Agreement.

Section 3 Application for Retention of Rothschild. In the event the Company determines to commence Chapter 11 proceedings, the Company shall apply promptly to the Bankruptcy Court pursuant to Sections 327(a) and 328(a) of the Bankruptcy Code, Rule 2014 of the Federal Rules of Bankruptcy Procedure, applicable local rules and procedural orders of the Bankruptcy Court and procedural guidelines established by the Office of the United States Trustee, for approval of (a) this Agreement and (b) Rothschild's retention by the Company under the terms of this Agreement, *nunc pro tunc* to the date the Chapter 11 cases was commenced, and shall use its best efforts to obtain Bankruptcy Court authorization thereof. The Company shall use its reasonable best efforts to obtain such Bankruptcy Court approval and authorization subject only to the subsequent review by the Bankruptcy Court under the standard of review provided in Section 328(a) of the Bankruptcy Code, and not subject to the standard of review set forth in Section 330 of the

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Bankruptcy Code. The Company shall supply Rothschild and its counsel with a draft of such application and any proposed order authorizing Rothschild's retention sufficiently in advance of the filing of such application and proposed order to enable Rothschild and its counsel to review and comment thereon. Rothschild shall have no obligation to provide any services under this Agreement unless Rothschild's retention under the terms of this Agreement is approved in the manner set forth above by a final order of the Bankruptcy Court which order is reasonably acceptable to Rothschild in all respects.

Rothschild acknowledges that in the event that the Bankruptcy Court approves its retention by the Company pursuant to the application process described in this Section 3, payment of Rothschild's fees and expenses shall be subject to (i) the jurisdiction and approval of the Bankruptcy Court under Section 328(a) of the Bankruptcy Code and any order approving Rothschild's retention, (ii) any applicable fee and expense guidelines and/or orders and (iii) any requirements governing interim and final fee applications. In the event that Rothschild's engagement hereunder is approved by the Bankruptcy Court, the Company shall pay all fees and expenses of Rothschild hereunder as promptly as practicable in accordance with the terms hereof and the orders governing interim and final fee applications, and after obtaining all necessary further approvals from the Bankruptcy Court, if any, provided, however, that the Company shall use its reasonable best efforts (including the filing of any necessary motions sufficiently in advance of the closing of any Transaction or similar transaction, or confirmation and effectiveness of a Plan) to provide for the payment of the fees set forth in Section 4 hereof to Rothschild simultaneously with the closing of such transaction or Transaction or Plan effectiveness, as applicable. In so agreeing to seek Rothschild's retention under Section 328(a) of the Bankruptcy Code, the Company acknowledges that it believes that Rothschild's general restructuring experience and expertise, and its knowledge of the industry in which the Company operates and the capital markets will inure to the benefit of the Company in pursuing any Transaction, that the value to the Company of Rothschild's services hereunder derives in substantial part from that expertise and experience and that, accordingly, the structure and amount of the Monthly Fee, the Completion Fee, and any New Capital Fee (as each is defined below) are reasonable regardless of the number of hours to be expended by Rothschild's professionals in performance of the services to be provided hereunder.

Section 4 Fees of Rothschild As compensation for the services rendered hereunder, the Company, and its successors, if any, agree to pay Rothschild (via wire transfer or other mutually acceptable means) the following fees in cash:

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(a) A retainer (the "Retainer") in an amount equal to \$400,000, payable upon the execution of this Agreement, to be applied against the fees and expenses of Rothschild under this Agreement.

(b) Commencing as of the date hereof, and whether or not a Transaction is proposed or consummated, an advisory fee (the "Monthly Fee") of \$200,000 per month. The initial Monthly Fee shall be pro-rated based on the commencement of services as of the date hereof and shall be payable by the Company upon the execution of this Agreement by each of the parties hereto, and thereafter the Monthly Fee shall be payable by the Company in advance on the first day of each month.

(c) A fee (the "Completion Fee") of \$6,000,000, payable in cash upon the earlier of (i) the confirmation and effectiveness of a Plan or (ii) the closing of another Transaction.

(d) If Rothschild is specifically requested by the Company, in writing, to provide services with respect to a New Capital Raise (as defined below), a fee (the "New Capital Fee") equal to (i) 1.50% of the face amount of any senior secured debt raised including, without limitation, any debtor-in-possession financing raised; (ii) 2.50% of the face amount of any junior secured debt raised (iii) 3.00% of the face amount of any senior or subordinated unsecured debt raised and (iv) 5.50% of any equity capital, or capital convertible into equity, raised (a "New Capital Raise"). The New Capital Fee shall be payable upon the closing of the transaction by which the new capital is committed. For the avoidance of doubt, the term "raised" shall include the amount committed or otherwise made available to the Company whether or not such amount (or any portion thereof) is drawn down at closing or is ever drawn down and any amount used to refinance existing obligations of the Company.

(e) In the event that the Company requests Rothschild's assistance with respect to (i) a sale or acquisition, directly or indirectly, of assets or equity interests or any securities convertible into, or options, warrants or other rights to acquire such equity interests, or other merger or consolidation, which sale or acquisition does not constitute a Transaction (any such transaction, an "M&A Transaction") or (ii) the Company intends to commence a Chapter 11 cases in order to consummate a Transaction, the Company and Rothschild agree to negotiate in good faith a written amendment to this Agreement to provide for a fee customary for M&A Transactions of the type contemplated.

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(f) To the extent the Company requests that Rothschild perform additional services not contemplated by this Agreement, such additional fees as shall be mutually agreed upon by Rothschild and the Company, in writing, in advance.

The Company and Rothschild acknowledge and agree that (i) the hours worked, (ii) the results achieved and (iii) the ultimate benefit to the Company of the work performed, in each case, in connection with this engagement, may be variable, and that the Company and Rothschild have taken such factors into account in setting the fees hereunder.

In the event the Company enters into a transaction that falls within more than one of the defined terms Transaction and M&A Transaction, Rothschild shall be entitled to the highest fee provided by those defined terms.

Section 5 Credit. Rothschild shall credit against the Completion Fee: (a) 30% of the Monthly Fees paid under Section 4(b) in excess of \$600,000 (the "Monthly Fee Credit"); (b) 50% of any New Capital Fees paid (the "New Capital Fee Credit"); (c) to the extent not otherwise applied against the fees and expenses of Rothschild under the terms of this Agreement, the balance of the Retainer; provided that the sum of the Monthly Fee Credit and the New Capital Fee Credit shall not exceed \$3,500,000.

Section 6 Expenses. Without in any way reducing or affecting the provisions of Exhibit A hereto, the Company shall reimburse Rothschild for its reasonable expenses incurred in connection with the performance of its engagement hereunder, and the enforcement of this Agreement, including without limitation the reasonable fees, disbursements and other charges of Rothschild's counsel. Reasonable expenses shall also include, but not be limited to, expenses incurred in connection with travel and lodging, data processing and communication charges, research and courier services. Rothschild shall use commercially reasonable efforts to minimize expenses in the performance of its services hereunder. In the event the Company becomes a debtor and/or a debtor-in-possession in a Chapter 11 case, consistent with and subject to any applicable order of the Bankruptcy Court, the Company shall promptly reimburse Rothschild for such expenses under this Section 6 upon presentation of an invoice or other similar documentation with reasonable detail.

Section 7 Indemnity. The Company agrees to the provisions of Exhibit A hereto which provide for indemnification by the Company of Rothschild and certain related persons. Such indemnification is an integral part of this Agreement and the terms thereof are incorporated by reference as if fully stated herein. Such indemnification shall survive

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any termination, expiration or completion of this Agreement or Rothschild's engagement hereunder.

Section 8 Term. The term of Rothschild's engagement shall commence as of the date hereof and extend until the consummation of a Transaction. This Agreement may be terminated by either the Company or Rothschild after sixty (60) days from the date hereof by providing thirty (30) days advance notice in writing. If terminated, Rothschild shall be entitled to payment of any fees for any monthly period which are due and owing to Rothschild upon the effective date of termination (including, without limitation, any additional Monthly Fees required by Section 4(b) hereof); however, any such Monthly Fees will be pro-rated for any incomplete monthly period of service, and Rothschild will be entitled to reimbursement of any and all reasonable expenses described in Section 6. Termination of Rothschild's engagement hereunder shall not affect or impair the Company's continuing obligation to indemnify Rothschild and certain related persons as provided in Exhibit A. Without limiting any of the foregoing, the Completion Fee and any New Capital Fee shall be payable in the event that, in the case of the Completion Fee, a Transaction or, in the case of any New Capital Fee, a transaction of the kind described in Section 4(d) or Section 4(e) hereof, is consummated at anytime prior to the expiration of fifteen (15) months after such termination, or a letter of intent or definitive agreement with respect thereto is executed at any time prior to fifteen (15) months after such termination (which letter of intent or definitive agreement subsequently results in the consummation of a Transaction or a transaction of the kind described in Section 4(d) or Section 4(e) hereof at any time), in each case (a) as to which Rothschild advised the Company hereunder prior to the termination of this Agreement or (b) which involves a party identified to the Company by Rothschild or with whom the Company had discussions regarding a Transaction or transaction of the kind described in Section 4(d) or Section 4(e) hereof, as applicable, in each case during the term of Rothschild's engagement hereunder .

Section 9 Miscellaneous.

(a) *Administrative Expense Priority.* In the event the Company determines to commence Chapter 11 cases, the Company agrees that Rothschild's post-petition compensation as set forth herein and payments made pursuant to reimbursement and indemnification provisions of this Agreement shall be entitled to priority as expenses of administration under Sections 503(b)(1)(A) and 507(a)(1) of the Bankruptcy Code and shall be entitled to the benefits of any "carve-outs" for professional fees and expenses in effect in such Chapter 11 cases pursuant to one or more financing orders entered by the Bankruptcy Court.

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(b) *Survival, Successors & Assigns.* Sections 4 through 9 hereof, inclusive, including the provisions set forth in Exhibit A hereto, shall survive the termination or expiration of this Agreement. The benefits of this Agreement and the indemnification and other obligations of the Company to Rothschild and certain related persons contained in Exhibit A hereto shall inure to the respective successors and assigns of the parties hereto and thereto and of the indemnified parties, and the obligations and liabilities assumed in this Agreement and Exhibit A by the parties hereto and thereto shall be binding upon their respective successors and assigns.

(c) *Benefit of Agreement; No Reliance by Third Parties.* The advice (oral or written) rendered by Rothschild pursuant to this Agreement is intended solely for the benefit and use of the Company and its professionals in considering the matters to which this Agreement relates, and the Company agrees that such advice may not be relied upon by any other person, used for any other purpose or reproduced, disseminated, quoted or referred to at any time, in any manner or for any purpose without the prior written consent of Rothschild.

(d) *Nature of Relationship.* The relationship of Rothschild to the Company hereunder shall be that of an independent contractor and Rothschild shall have no authority to bind, represent or otherwise act as agent, executor, administrator, trustee, lawyer or guardian for the Company, nor shall Rothschild have the authority to manage money or property of the Company. The parties hereto acknowledge and agree that by providing the services contemplated hereunder, Rothschild will not act, nor will it be deemed to have acted, in any managerial or fiduciary capacity whatsoever with respect to the Company or any third party including security holders, creditors or employees of the Company.

(e) *Required Information.* Since Federal law requires Rothschild to obtain, verify, and record information that identifies any entity not listed on the New York Stock Exchange, the American Stock Exchange or whose common stock or equity interests have not been designated as a National Market System security listed on the NASDAQ stock market that enters into a formal relationship with it, the Company agrees to provide Rothschild with its tax or other similar identification number and/or other identifying documents, as Rothschild may request, to enable it to comply with applicable law. For your information, Rothschild may also screen the Company against various databases to verify its identity.

(f) *Public Announcements.* The Company acknowledges that Rothschild may at its option and expense, after announcement of the Transaction or New Capital Raise,

Tronox Worldwide LLC
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Page 11

place announcements and advertisements or otherwise publicize the transaction in such financial and other newspapers and journals as it may choose, stating that Rothschild acted as financial advisor to the Company in connection with such transaction. Company further consents to Rothschild's public use or display of Company's logo, symbol or trademark as part of Rothschild's general marketing or promotional activities, provided such use or display is in the nature of a public record or tombstone announcement in relation to the Transaction or New Capital Raise.

(g) **CHOICE OF LAW: JURISDICTION.** THIS AGREEMENT HAS BEEN NEGOTIATED, EXECUTED AND DELIVERED AT AND SHALL BE DEEMED TO HAVE BEEN MADE IN NEW YORK, NEW YORK. THIS AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED IN ACCORDANCE WITH THE LAWS OF THE STATE OF NEW YORK, WITHOUT GIVING EFFECT TO SUCH STATE'S PRINCIPLES OF CONFLICTS OF LAWS. REGARDLESS OF ANY PRESENT OR FUTURE DOMICILE OR PRINCIPAL PLACE OF BUSINESS OF THE PARTIES HERETO, EACH SUCH PARTY HEREBY IRREVOCABLY CONSENTS AND AGREES THAT ANY AND ALL CLAIMS OR DISPUTES BETWEEN THE PARTIES HERETO PERTAINING TO THIS AGREEMENT OR TO ANY MATTER ARISING OUT OF OR RELATED TO THIS AGREEMENT SHALL BE BROUGHT IN ANY OF (A) ANY STATE OR FEDERAL COURT OF COMPETENT JURISDICTION IN THE STATE OF NEW YORK OR (B) THE BANKRUPTCY COURT OR ANY COURT HAVING APPELLATE JURISDICTION OVER THE BANKRUPTCY COURT. BY EXECUTION AND DELIVERY OF THIS AGREEMENT, EACH PARTY SUBMITS AND CONSENTS IN ADVANCE TO SUCH JURISDICTION IN ANY ACTION OR SUIT COMMENCED IN ANY SUCH COURT. EACH PARTY HERETO HEREBY WAIVES ANY OBJECTION WHICH IT MAY HAVE BASED ON LACK OF PERSONAL JURISDICTION, IMPROPER VENUE OR FORUM NON CONVENIENS AND HEREBY CONSENTS TO THE GRANTING OF SUCH LEGAL OR EQUITABLE RELIEF AS IS DEEMED APPROPRIATE BY SUCH COURT. THE COMPANY CONSENTS TO THE SERVICE OF PROCESS IN ACCORDANCE WITH NEW YORK LAW AND AGREES THAT THE COMPANY'S SERVICE AGENT IN NEW YORK SHALL BE AUTHORIZED TO ACCEPT SERVICE ON ITS BEHALF. THE COMPANY'S CURRENT SERVICES AGENT IS CT CORPORATION. THE COMPANY SHALL PROVIDE REASONABLY PROMPT WRITTEN NOTICE TO ROTHSCHILD IN THE EVENT THAT ITS SERVICE AGENT CHANGES.

(h) **Waiver of Jury Trial.** Each of the parties hereto hereby knowingly, voluntarily and irrevocably waives any right it may have to a trial by jury in respect of any

Tronox Worldwide LLC
As of May 1, 2008
Page 12

claim upon, arising out of or in connection with this Agreement or any Transaction. Each of the parties hereto hereby certifies that no representative or agent of any other party hereto has represented expressly or otherwise that such party would not seek to enforce the provisions of this waiver. Each of the parties hereto hereby acknowledges that it has been induced to enter into this Agreement by and in reliance upon, among other things, the provisions of this paragraph.

(i) *Entire Agreement.* This Agreement, including Exhibit A hereto, embodies the entire agreement and understanding of the parties hereto and supersedes any and all prior agreements, arrangements and understandings relating to the matters provided for herein. No alteration, waiver, amendment, change or supplement hereto shall be binding or effective unless the same is set forth in writing signed by a duly authorized representative of each of the parties hereto.

(j) *Authority.* Each party hereto represents and warrants that it has all requisite power and authority to enter into this Agreement and Exhibit A attached hereto and the transactions contemplated hereby. Each party hereto further represents that this Agreement has been duly and validly authorized by all necessary corporate action and has been duly executed and delivered by each of the parties hereto and constitutes the legal, valid and binding agreement thereof, enforceable in accordance with its terms. Rothschild will assume that any instructions, notices or requests have been properly authorized by the Company if they are given or purported to be given by, or is reasonably believed by Rothschild to be a director, officer, employee or authorized agent.

(k) *Counterparts.* This Agreement may be executed in as many counterparts as may be deemed necessary and convenient, and by the different parties hereto on separate counterparts, each of which when so executed shall be deemed an original, but all such counterparts shall constitute one and the same instrument. Delivery of an executed counterpart of a signature page to this Agreement by telecopier shall be effective as delivery of a manually executed counterpart to this Agreement.

If the foregoing correctly sets forth the understanding and agreement between Rothschild and the Company, please so indicate by signing the enclosed copy of this letter, whereupon it shall become a binding agreement between the parties hereto as of the date first above written.

Very truly yours,

ROTHSCHILD INC.

By: 

Todd Snyder
Managing Director

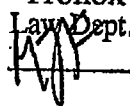
Accepted and Agreed to as of
the date first written above:

Tronox Worldwide LLC, on behalf of
itself and its direct and indirect subsidiaries

By: 

Name: Robert Y. Brown, III

Title: President

Tronox
Law Dept.


Rothschild Inc.
1251 Avenue of the Americas
New York, NY 10020
www.rothschild.com
212 457 2572

Todd Snyder
Managing Director
Telephone 212 403-5246
Facsimile 212 403-5454
Email todd.snyder@us.rothschild.com

Exhibit A

The Company shall indemnify and hold harmless Rothschild and its affiliates, counsel and other professional advisors, and the respective directors, officers, controlling persons, agents and employees of each of the foregoing (Rothschild and all of such other persons collectively, the "Indemnified Parties"), from and against any losses, claims or proceedings, including without limitation, stockholder actions, damages, judgments, assessments, investigation costs, settlement costs, fines, penalties, arbitration awards and any other liabilities, costs, fees and expenses (collectively, "Losses") (a) directly or indirectly related to or arising out of (i) oral or written information provided by the Company, the Company's employees or other agents, which either the Company or an Indemnified Party provides to any person or entity or (ii) any other action or failure to act by the Company, the Company's employees or other agents or any Indemnified Party at the Company's request or with the Company's consent, in each case in connection with, arising out of, based upon, or in any way related to this Agreement, the retention of and services provided by Rothschild under this Agreement, or any Transaction or other transaction; or (b) otherwise directly or indirectly in connection with, arising out of, based upon, or in any way related to the engagement of Rothschild under this Agreement or any transaction or conduct in connection therewith, provided that the Company shall not be required to indemnify any Indemnified Party for such Losses if and only to the extent that it is finally judicially determined by a court of competent jurisdiction that such Losses arose primarily because of the gross negligence, willful misconduct or fraud of such Indemnified Party. If multiple claims are brought against an Indemnified Party, with respect to at least one of which indemnification is permitted under applicable law and provided for under this Agreement, the Company agrees that any judgment or arbitration award shall be conclusively deemed to be based on claims as to which indemnification is permitted and provided for, except to the extent the judgment or arbitration award expressly states that it, or any portion thereof, is based on a claim as to which indemnification is not available.

The Company shall further reimburse any Indemnified Party promptly after obtaining the necessary approval of the Bankruptcy Court, if any, for any expenses including, but not limited to, legal or other fees, disbursements or expenses as they are incurred (a) in investigating, defending against, settling, preparing or pursuing any action or other proceeding (whether formal or informal) or threat thereof, whether or not in connection with pending or threatened litigation or arbitration and whether or not any Indemnified Party is a party (each, an "Action") and (b) in connection with enforcing such Indemnified Party's rights under this Agreement; provided, however, that in the event and only to the extent that it is finally judicially determined by a court of competent jurisdiction that the Losses of such Indemnified Party arose primarily because of the gross

Tronox Worldwide LLC
As of May 1, 2008
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negligence, willful misconduct or fraud of such Indemnified Party, such Indemnified Party will promptly remit to the Company any amounts reimbursed under this paragraph.

Upon receipt by an Indemnified Party of notice of any Action, such Indemnified Party shall notify the Company in writing of such Action, but the failure to so notify shall not relieve the Company from any liability hereunder (i) if the Company had actual notice of such Action or (ii) unless and only to the extent that such failure results in the forfeiture by the Company of substantial rights and defenses. The Company shall, if requested by Rothschild, assume the defense of any such Action including the employment of counsel reasonably satisfactory to Rothschild and will not, without the prior written consent of Rothschild, settle, compromise, consent or otherwise resolve or seek to terminate any pending or threatened Action (whether or not any Indemnified Party is a party thereto) unless such settlement, compromise, consent or termination (a) contains an express, unconditional release of each Indemnified Party from all liability relating to such Action and the engagement of Rothschild under this Agreement and (b) does not include a statement as to, or an admission of fault, culpability or a failure to act by or on behalf of any Indemnified Party. Any Indemnified Party shall be entitled to retain separate counsel of its choice and participate in the defense of any Action in connection with any of the matters to which this Agreement relates, but the fees and expenses of such counsel shall be at the expense of such Indemnified Party unless (x) the Company has failed promptly to assume the defense and employ counsel or (y) the named parties to any such Action (including any impleaded parties) include such Indemnified Party and the Company, and such Indemnified Party shall have been advised by counsel that there may be one or more legal defenses available to it which are different from or in addition to those available to the Company; provided that the Company shall not in such event be responsible under this Agreement for the fees and expenses of more than one firm of separate counsel (in addition to local counsel) in connection with any such Action in the same jurisdiction.

The Company agrees that if any right of any Indemnified Party set forth in the preceding paragraphs is finally judicially determined to be unavailable (except by reason of the gross negligence, willful misconduct or fraud of such Indemnified Party), or is insufficient to hold such Indemnified Party harmless against such Losses as contemplated herein, then the Company shall contribute to such Losses (a) in such proportion as is appropriate to reflect the relative benefits received by the Company and its creditors and stockholders, on the one hand, and such Indemnified Party, on the other hand, in connection with the transactions contemplated hereby, and (b) if (and only if) the

Tronox Worldwide LLC

As of May 1, 2008

Page 3

allocation provided in clause (a) is not permitted by applicable law, in such proportion as is appropriate to reflect not only the relative benefits referred to in clause (a) but also the relative fault of the Company and such Indemnified Party; provided, that, in no event shall the aggregate contribution of all such Indemnified Parties exceed the amount of fees received by Rothschild under this Agreement. Benefits received by Rothschild shall be deemed to be equal to the compensation paid by the Company to Rothschild in connection with this Agreement. Relative fault shall be determined by reference to, among other things, whether any alleged untrue statement or omission or any other alleged conduct relates to information provided by the Company or other conduct by the Company (or the Company's employees or other agents) on the one hand or by Rothschild on the other hand.

The Company also agrees that no Indemnified Party shall have any liability (whether direct or indirect, in contract or tort or otherwise) to the Company for or in connection with advice or services rendered or to be rendered by any Indemnified Party pursuant to this Agreement, the transactions contemplated hereby or any Indemnified Party's actions or inactions in connection with any such advice, services or transactions except for and only to the extent that such Losses of the Company are finally judicially determined by a court of competent jurisdiction to have arisen primarily because of the gross negligence, willful misconduct or fraud of such Indemnified Party in connection with any such advice, actions, inactions or services.

The rights of the Indemnified Parties hereunder shall be in addition to any other rights that any Indemnified Party may have at common law, by statute or otherwise. Except as otherwise expressly provided for in this Agreement, if any term, provision, covenant or restriction contained in this Agreement is held by a court of competent jurisdiction or other authority to be invalid, void, unenforceable or against its regulatory policy, the remainder of the terms, provisions, covenants and restrictions contained in this Agreement shall all remain in full force and effect and shall in no way be affected, impaired or invalidated. The reimbursement, indemnity and contribution obligations of the Company set forth herein shall apply to any modification of this Agreement and shall remain in full force and effect regardless of any termination of, or the completion of any Indemnified Party's services under or in connection with, this Agreement.

December 4, 2008

Tronox Worldwide LLC
One Leadership Square
Suite 300, 211 N. Robinson Avenue
Oklahoma City, Oklahoma 73102
Attn: Michael J. Foster
Vice President and General Counsel

Dear Mr. Foster:

This letter (the "Letter Agreement") will amend the engagement letter (the "Engagement Letter"), dated as of May 1, 2008, between Tronox Worldwide LLC (together with its parent and direct and indirect subsidiaries, the "Company") and Rothschild Inc. ("Rothschild"), as follows (capitalized terms used herein and not otherwise defined shall have the meanings assigned to such terms in the Engagement Letter):

1. The penultimate paragraph of Section 1 of the Engagement Letter is hereby amended by deleting "not" from the last sentence thereof.

2. The last paragraph of Section 1 of the Engagement Letter is hereby amended by deleting the last sentence thereof.

3. The last sentence of the last paragraph of Section 3 of the Engagement Letter is hereby amended and restated in its entirety to read as follows:

"In agreeing to seek Rothschild's retention under Section 328(a) of the Bankruptcy Code, the Company acknowledges that it believes that Rothschild's general restructuring experience and expertise, its knowledge of the industry in which the Company operates and the capital markets and its merger and acquisition capabilities will inure to the benefit of the Company, that the value to the Company of Rothschild's services hereunder derives in substantial part from that expertise and experience and that, accordingly, the structure and amount of the Monthly Fee, the Completion Fee, the New Capital Fee and the M&A Fee (each as defined below) are reasonable regardless of the number of hours expended by Rothschild's professionals in performance of the services provided hereunder."

4. Clause (e) of Section 4 of the Engagement Letter is hereby amended and restated in its entirety to read as follows:

"(e) A fee (the "M&A Fee") as specified in Exhibit B hereto if (i) the

Rothschild Inc.
1251 Avenue of the Americas
New York, NY 10020
212 403 5246
www.rothschild.com

Todd R. Snyder
Managing Director
Telephone 212 403-5246
Facsimile 212 403-5454
Email todd.snyder@us.rothschild.com

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December 4, 2008
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Company sells or acquires, directly or indirectly, through a credit bid or otherwise, assets or equity interests or any securities convertible into, or options, warrants or other rights to acquire such equity interests, or otherwise consummates any merger or consolidation, which transaction does not constitute a Transaction (any such transaction, an "M&A Transaction") and (ii) Rothschild provides services (including, without limitation, any services of the kind contemplated under this Agreement) in connection with such M&A Transaction, which fee shall be payable at the closing of any M&A Transaction."

5. Section 5 of the Engagement Letter is hereby amended and restated in its entirety to read as follows:

Credit. Rothschild shall credit against the Completion Fee: (a) 30% of the Monthly Fees paid under Section 4(b) in excess of \$600,000 (the "Monthly Fee Credit"); (b) 30% of any M&A Fees paid (the "M&A Fee Credit"); (c) 50% of any New Capital Fees paid (the "New Capital Fee Credit"); and (d) to the extent not otherwise applied against the fees and expenses of Rothschild under the terms of this Agreement, the Retainer (the "Retainer Credit"); provided that the sum of the Monthly Fee Credit, the M&A Fee Credit, the New Capital Fee Credit and the Retainer Credit shall not exceed \$3,500,000.

6. Section 8 of the Engagement Letter is hereby amended and restated in its entirety to read as follows:

"The term of Rothschild's engagement shall commence on the date hereof and shall extend until the consummation of a Transaction. This Agreement may be terminated by either the Company or Rothschild after sixty (60) days from the date hereof by providing thirty (30) days advance notice in writing. If terminated, (a) Rothschild shall be entitled to reimbursement of any and all reasonable expenses described in Section 6 and (b) Rothschild shall be entitled to payment of any fees which are due and owing to Rothschild upon the effective date of termination; provided, that the final Monthly Fee will be prorated for any incomplete monthly period of service. Termination of Rothschild's engagement hereunder shall not affect or impair the Company's continuing obligation to indemnify Rothschild and certain related persons as provided in Exhibit A. Without limiting any of the foregoing, the Completion Fee, New Capital Fee(s) and M&A Fee(s) shall be payable in the event that (a) as applicable, a Transaction, an M&A Transaction or a New Capital Raise, is

Tronox Worldwide LLC
December 4, 2008
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consummated at any time prior to the expiration of fifteen (15) months after such termination, or (b) a letter of intent or definitive agreement with respect thereto is executed at any time prior to fifteen (15) months after such termination (which letter of intent or definitive agreement subsequently results in the consummation of a Transaction, an M&A Transaction or a New Capital Raise, as applicable, at any time).”

6. Exhibit B to the Engagement Letter is attached hereto as Exhibit 1.

7. The Company hereby requests Rothschild’s assistance with respect to a New Capital Raise of debtor-in-possession financing.

8. Except as expressly amended hereby, the Engagement Letter is in all respects ratified and confirmed and all the terms thereof shall be and remain in full force and effect. In addition, the parties hereto expressly agree that Exhibit A to the Engagement Letter providing for the indemnification by the Company of Rothschild and certain related persons and entities shall remain in full force and effect and shall be deemed to cover the Engagement Letter as amended hereby.

AMERICAN BANKRUPTCY INSTITUTE

Tronox Worldwide LLC
December 4, 2008
Page 4

If you are in agreement with the terms of this Letter Agreement, please so indicate by signing the enclosed copy of this Letter Agreement in the space designated below and returning it to us whereupon this Letter Agreement shall be binding upon the parties hereto.

Sincerely,

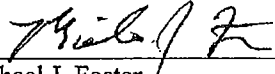
ROTHSCHILD INC.

By: 

Todd R. Snyder
Managing Director

Agreed and Accepted:

TRONOX WORLDWIDE LLC, on behalf
of itself and direct and indirect subsidiaries

By: 
Michael J. Foster
Vice President and General Counsel

351463

22848157v2

EXHIBIT 1 TO LETTER AGREEMENT

Exhibit BM&A Fee Schedule

(Dollars In Millions)

<u>Aggregate Consideration</u>	<u>M&A Fee Percentage</u>
<\$200.0	1.40
300.0	1.30
400.0	1.20
500.0	1.075
600.0	0.975
700.0	0.875
800.0	0.825
900.0	0.775
1,000.0+	0.725

- (a) For purposes hereof, the term "Aggregate Consideration" shall mean the total amount of all cash plus the total value (as determined pursuant hereto) of all securities, contractual arrangements (including, without limitation, any lease arrangements or put or call agreements) and other consideration, including, without limitation, any contingent or earned consideration, paid or payable, directly or indirectly, in connection with an M&A Transaction (including, without limitation, amounts paid (i) pursuant to covenants not to compete, employment contracts, employee benefit plans, management fees or other similar arrangements, and (ii) to holders of any warrants, stock purchase rights or convertible securities of the Company and to holders of any options or stock appreciation rights issued by the Company, whether or not vested). Aggregate Consideration shall also include the amount of any short-term liabilities (including, without limitation, any trade or ordinary course liabilities) and any long-term liabilities of the Company (including, without limitation, the principal amount of any indebtedness for borrowed money and capitalized leases and the full amount of any off-balance sheet financings) (x) repaid, defeased or retired, directly or indirectly, in connection with or in anticipation of an M&A Transaction or (y) existing on the Company's balance sheet at the time of an M&A Transaction (if such M&A Transaction takes the form of a merger, consolidation or a sale of stock or partnership interests) or assumed in connection with an M&A Transaction (if such M&A Transaction takes the form of a sale of assets). In the event such M&A Transaction takes the form of a sale of assets, Aggregate Consideration shall include (i) the value of any current assets not purchased, minus (ii) the value of any current liabilities not

Tronox Worldwide LLC
December 4, 2008
Page 2

assumed. In the event such M&A Transaction takes the form of a recapitalization, restructuring, spin-off, split-off or similar transaction, Aggregate Consideration shall include the fair market value of (i) the equity securities of the Company retained by the Company's security holders following such M&A Transaction and (ii) any securities received by the Company's security holders in exchange for or in respect of securities of the Company following such M&A Transaction (all securities received by such security holders being deemed to have been paid to such security holders in such M&A Transaction). The value of securities that are freely tradable in an established public market will be determined on the basis of the last market closing price prior to the consummation of an M&A Transaction. The value of securities that are not freely tradable or have no established public market, or if the consideration consists of property other than securities, the value of such property shall be the fair market value thereof as determined in good faith by the Company and Rothschild, provided, however, that all debt securities shall be valued at their stated principal amount without applying a discount thereto. If the consideration to be paid is computed in any foreign currency, the value of such foreign currency shall, for purposes hereof, be converted into U.S. dollars at the prevailing exchange rate on the date or dates on which such consideration is payable. Aggregate Consideration shall also include the face amount of any liabilities tendered as purchase price in connection with any credit bid.

- (b) Percentages rounded to two decimal places. The applicable M&A Fee percentage for Aggregate Consideration value amounts which fall between the amounts listed above shall be calculated based on a straight line interpolation of the percentages in the M&A Fee Schedule. For Aggregate Consideration value amounts which fall below or above the amounts listed above, the applicable M&A Fee percentage shall be agreed upon by Rothschild and the Company in good faith consistent with the above fee schedule.

Feature

BY JO ANN J. BRIGHTON, CHARLES A. DALE III AND NICHOLAS M. MCGRATH

Existence of a Third-Party Source of Payment Is Sufficient to Distinguish Unsecured Claims



Jo Ann J. Brighton
K&L Gates LLP
Charlotte, N.C.,
and New York



Charles A. Dale III
K&L Gates LLP; Boston



Nicholas M. McGrath
K&L Gates LLP; Boston

Jo Ann Brighton is a partner at K&L Gates LLP in Charlotte, N.C., and New York. Charles Dale III is a partner and Nicholas McGrath is an associate in the firm's Boston office. Ms. Brighton serves on ABI's Board of Directors and co-authored Handbook on Second Lien Loans & Intercreditor Agreements (ABI, 2009), and Mr. McGrath is a coordinating editor for the ABI Journal.

One of the immutable requirements for a chapter 11 plan is that every creditor within a class of creditors must receive the same treatment.¹ The Bankruptcy Code is more flexible, however, when it comes to the classification of creditor claims. Specifically, § 1122(a) permits a plan proponent to place a claim within a class of claims if such claim is “substantially similar” to other claims within the class.² Understanding the permissive nature of this section is critical in the formulation of a confirmable plan. That is, while § 1122(a) mandates separate classification for dissimilar claims, it does not require that similar claims be classified in one class. The interpretation of § 1122(a) has been the source of much controversy over the years, most frequently in situations where an undersecured creditor has accused a plan proponent of “gerrymandering” classes of claims solely to create an accepting impaired class that will satisfy the confirmation requirement found in § 1129(a)(10).³ The Bankruptcy Appellate Panel (BAP) for the Ninth Circuit recently confronted this situation in *In re Loop 76 LLC*,⁴ in which a debtor separately classified the unsecured deficiency claim of its primary lender, arguing that the lender’s claim was not substantially similar to other unsecured creditors because the lender had a third-party guarantor as an additional source of recovery for its claim. The BAP affirmed the bankruptcy court’s decision to uphold the debtor’s classification scheme, holding that a third-party source of recovery is a factor that bankruptcy courts may consider when determining whether claims are substantially similar under § 1122(a).⁵

Only three months later, a California bankruptcy court emphatically disagreed with the analysis and holding in *Loop*, determining that an undersecured deficiency claim could not be classified separately from other unsecured claims solely due to the existence of a nondebtor source of payment (*i.e.*, a personal guaranty).⁶ Although this latter decision may read too much into the BAP’s decision in *Loop*, it

highlights the unsettled nature of the law in the area of claims classification.

In re Loop 76 LLC

In re Loop 76 LLC involved a mixed-use office and retail property development in Scottsdale, Ariz.⁷ The debtor, a real estate developer, had obtained a \$23 million construction loan from Wells Fargo in 2005.⁸ The loan was personally guaranteed by at least three of the debtor’s principals (and their spouses).⁹ After the debtor failed to secure permanent financing for the project, in 2009 the bank filed suit against the debtor and sought the appointment of a receiver.¹⁰ Separately, the bank sued each of the guarantors.¹¹ In response, the debtor sought chapter 11 relief.¹²

Under a reorganization plan proposed by the debtor, the bank would receive a 10-year payout of a \$17 million secured claim and a 10 percent distribution on a \$6 million unsecured deficiency claim. The bank’s deficiency claim was placed in a class separate and apart from other unsecured creditors.¹³ The bank challenged the proposed classification of unsecured claims, arguing that the debtor failed to provide any business or economic justification for separately classifying its deficiency claim and that the debtor was effectively “gerrymandering” an accepting impaired class.¹⁴ The bank further argued that the proper method to determine whether claims are substantially similar under § 1122(a) is “to evaluate the ‘nature’ of the claim as it relates to assets of the debtor, not on factors extrinsic to the bankruptcy case.”¹⁵ In other words, the bank contended that the existence of a third-party source of payment, *i.e.*, the fact that the bank could potentially recover from individual guarantors, did not justify separately classifying its deficiency claim because the guarantees did not alter the nature or priority of the unsecured claim *against the debtor*.¹⁶

The debtor argued that a more flexible standard for claim classification prevailed in the Ninth

1 11 U.S.C. § 1123(a)(4) (2012).
2 11 U.S.C. § 1122(a) (2012).
3 See, e.g., *In re Save Our Springs (S.O.S.) Alliance Inc.*, 388 B.R. 202, 233 (Bankr. W.D. Tex. 2008).
4 *In re Loop 76 LLC*, 465 B.R. 525, 541 (9th Cir. B.A.P. 2012).
5 *Id.* at 545.
6 See *In re 4th Street East Investors Inc.*, 2012 WL 1745500 (Bankr. C.D. Cal. May 15, 2012).

7 *Loop*, 465 B.R. at 529.
8 *Id.*
9 *Id.*
10 *Id.*
11 *Id.*
12 *Id.*
13 *Id.* at 530.
14 *Id.*
15 *Id.* at 533.
16 *Id.*

Circuit, which allowed courts to “look beyond the legal nature or rank of the claim as to the debtor” and consider other circumstantial factors.¹⁷ According to the debtor, § 1122(a) mandated separate classification of the bank’s deficiency claim because (1) the claim was partially secured, (2) the bank was engaged in state court litigation with numerous personal guarantors who were a third-party source of payment on the debt and (3) the bank might be paid, in full, before other creditors if it was successful in its state court litigation against the guarantors.¹⁸ For these reasons, the debtor maintained that the bank’s deficiency claim was not “substantially similar” to other unsecured claims.¹⁹

The bankruptcy court sided with the debtor, finding that the language, structure and purpose of § 1122(a), the history of classification under the Bankruptcy Act and the Bankruptcy Code, and applicable Ninth Circuit case law supported the conclusion that “a claimant who has a third-party source of repayment for its claim is *dissimilar* from a claimant who lacks such alternative sources of payment.”²⁰

On appeal, the BAP framed the issue narrowly: whether bankruptcy courts are allowed to consider whether a creditor has a third-party source for payment of its unsecured claim when determining whether a creditor’s claim is “substantially similar” to other unsecured claims.²¹ The BAP explained that the first step in determining proper classification under § 1122(a) is to decide whether the claims are “substantially similar.”²² If the claims in question are found to be substantially similar, a debtor may either classify them together or place them in different classes, *but only if* the debtor can establish a business or economic justification for doing so.²³ If the claims are not substantially similar, then the inquiry must end because § 1122(a) mandates that dissimilar claims be placed in separate classes.²⁴ The BAP observed that many bankruptcy courts conflate this two-step analysis, bypassing an analysis of whether the claims are substantially similar and moving directly to a determination of whether gerrymandering has occurred or whether the plan proponent has illustrated a business or economic justification for separately classifying similar claims.²⁵ The BAP then turned its attention to *Steelcase Inc. v. Johnston* (*In re Johnston*), the leading decision in the Ninth Circuit on the issue of classification.²⁶

In *Johnston*, the U.S. Court of Appeals for the Ninth Circuit was asked to decide the proper standard for determining when an unsecured claim may be classified separately from other unsecured claims under § 1122(a).²⁷ James E. Johnston filed chapter 11 cases both for himself and his company, Capital Office Systems Inc. (COS).²⁸ Steelcase filed a \$2 million claim against COS, a claim that was secured by office furniture and equipment sold to COS pursuant to a financing agreement that was personally guaranteed by Johnston.²⁹ In his indi-

vidual case, Johnston proposed a plan that placed Steelcase’s unsecured guarantee claim in its own class.³⁰ The bankruptcy court and BAP agreed that Steelcase’s claim against Johnston was properly classified.³¹ Both courts reasoned that Steelcase’s claim was not substantially similar to Johnston’s other unsecured claims, and therefore, separate classification was proper.³² On appeal, the Ninth Circuit affirmed, holding that separate classification of Steelcase’s claim did not violate § 1122(a) because “the legal character of [the Steelcase] claim [was] *not* substantially similar to the other claims” inasmuch as Steelcase (1) held a partially secured interest in assets belonging to COS, (2) was the only unsecured creditor whose claim was being litigated and (3) could have its claim paid, in full, before Johnston’s other unsecured claims if it was successful in the litigation.³³

In *Loop*, the BAP concluded that the Ninth Circuit’s ruling in *Johnston* was consistent with the Bankruptcy Code’s more flexible approach to claim classification than the pre-Code case law—in particular, *In re Los Angeles Land & Invs. Ltd.*³⁴ The BAP commented that while the Ninth Circuit’s decision in *Johnston* did not expressly overrule *Los Angeles Land*, the circuit court rejected the “narrow definition of ‘nature’ of the claim by holding that, at a minimum, a bankruptcy court may consider sources outside of the debtor’s assets, such as the potential recovery from a nondebtor or nonstate source.”³⁵ The BAP also reconciled *Johnston* with the Ninth Circuit’s 1996 decision in *In re Barakat*, which held that specific characteristics or “special circumstances” may be considered when a debtor separately classifies unsecured claims, including deficiency claims.³⁶ The BAP explained that because the bank had a third-party source of recovery for its deficiency claim (*i.e.*, the guarantors, whom it has already sued), its deficiency claim had distinguishing characteristics from the other unsecured claims.³⁷ For this reason, the BAP found that there was at least one “special circumstance” that did not apply to other unsecured claimants.³⁸ The BAP also stated that there was no legal distinction between the availability of collateral pledged by a third party, or a third-party guaranty, when determining the similarity of the claims.³⁹ In light of *Johnston* and *Barakat*, the BAP ruled that the existence of a third-party source for payment should be considered when determining whether unsecured claims are substantially similar.⁴⁰

In re 4th Street East Investors Inc.

Three months after the BAP rendered its decision in *Loop*, the U.S. Bankruptcy Court for the Central District of California issued a decision in *In re 4th Street East Investors*

17 *Id.*

18 *Id.* at 531.

19 *Id.*

20 *Id.* at 533-34 (citing *Loop*, 442 B.R. at 714).

21 *Id.* at 535.

22 *Id.* at 536.

23 *Id.*

24 *Id.*

25 *Id.* at 537.

26 *Id.* (citing *Steelcase Inc. v. Johnston* (*In re Johnston*), 21 F.3d 323 (9th Cir. 1994)).

27 *Johnston*, 21 F.3d at 324.

28 *Id.*

29 *Loop*, 465 B.R. at 537 (citing *Johnston*, 21 F.3d at 325).

30 *Id.*

31 *Johnston*, 21 F.3d at 324.

32 *Id.* at 326.

33 *Id.* at 328.

34 *Id.* at 540 (citing *In re Los Angeles Land & Invs. Ltd.*, 282 F.Supp. 448, 453-54 (D. Haw. 1968), *aff’d*, 447 F.2d 1366, 1367 (9th Cir. 1971)).

35 *Id.*

36 *Id.* at 541 (citing *Barakat v. Life Ins. Co. of Va.* (*In re Barakat*), 99 F.3d 1520, 1526 (9th Cir. 1996) (noting that bankruptcy court in *Loop* engaged in same analysis that Ninth Circuit did in *Johnston* and *Barakat*, however, unlike *Barakat*, bankruptcy court found that creditor’s deficiency claim did have distinguishing characteristics that rendered it dissimilar from unsecured trade claims).

37 *Id.*

38 *Id.*

39 *Id.*

40 *Id.*

continued on page 77

Existence of a Third-Party Source of Payment Is Sufficient

from page 31

Inc. criticizing the BAP's analysis and conclusion in *Loop*.⁴¹ In *4th Street East*, the debtor commenced a chapter 11 case after the storage facility it owned and operated suffered cash-flow problems caused by an increase in vacant storage units and a large maturing debt coming owed to Coastline RE Holdings Corp.⁴² The debtor's chapter 11 plan proposed to separately classify Coastline's general unsecured deficiency claim from other general unsecured claims because Coastline held a personal guaranty from the debtor's principal.⁴³ Coastline challenged the classification of its deficiency claim, arguing that the BAP's decision in *Loop* should not apply because the guarantor in this case was effectively "judgment proof."⁴⁴

In *4th Street East*, the bankruptcy court began its analysis by attacking the BAP's analysis in *Loop*.⁴⁵ In particular, the bankruptcy court questioned whether the mere existence of a guaranty required separate classification of claims.⁴⁶ In this regard, the bankruptcy court in *4th Street East* agreed with the bankruptcy court in *Loop* that the collectability of any third-party source of payment should be considered in a classification analysis under § 1122(a).⁴⁷ The court stated that the "special circumstances" identified in *Johnston* and *Barakat* on which the BAP relied in *Loop* went beyond the mere existence of a potential third-party source of repayment and took into account additional circumstances such as collateral securing the deficiency claim, litigation that may impact the creditor's rights (in addition to the amount of its claim), and the collectability of any personal guaranty.⁴⁸

Unlike the "special circumstances" present in *Johnston*, the court in *4th Street East* noted that this case did not involve any nondebtor collateral securing the deficiency, no pending litigation that could establish different rights for Coastline compared to the rights of general unsecured creditors and no proof that Coastline's claim was collectable from any nondebtor source.⁴⁹ For these reasons, the court determined that Coastline's deficiency claim was not dissimilar

from other unsecured creditors, and therefore separate classification of its deficiency claim was not required.⁵⁰ The court next analyzed whether there was a "legitimate business or economic justification" for separately classifying the claims that would not amount to gerrymandering.⁵¹ In this regard, the court found that the debtor had offered no justification for separately classifying Coastline's deficiency claim other than wanting to confirm its plan.⁵² As a result, the court rejected the debtor's proposed classification scheme.

Conclusion

The Bankruptcy Code requires that dissimilar claims be separately classified under a chapter 11 plan. Also, it is fairly well settled that bankruptcy courts may allow substantially similar claims to be placed in separate classes based on special circumstances, or reasonable business or economic justifications. What remains unsettled, however, are the following questions: (1) what characteristics make one claim dissimilar from another claim, and (2) what special circumstances justify separate classification of substantially similar claims? The BAP's decision in *Loop* and the bankruptcy court's decision in *4th Street East* highlight the lingering tension as to both of these issues.

Perhaps the most significant aspect of the *Loop* decision is the BAP's ruling that the analysis of whether a claim is substantially similar to another claim is not confined to the way in which the claim at issue relates to the debtor's assets, and that bankruptcy courts should take into account other "special circumstances." The bankruptcy court in *4th Street East* interpreted *Loop* to require separate classification of an unsecured lender's deficiency claim based on the mere existence of a personal guaranty or third-party source of payment. While this appears to be an overly broad reading of *Loop*, *4th Street East* underscores the strongly held difference of opinion between those who believe that a third-party source of payment mandates separate classification and those who believe that a third-party source of payment does not mandate separate classification and that it may not even justify separate classification under a "special circumstances"-type analysis. Which view prevails remains to be decided. **abi**

⁴¹ See *4th Street East*, 2012 WL 1745500 at *4-10.

⁴² *Id.* at *1.

⁴³ *Id.* at *4.

⁴⁴ *Id.* (Coastline's argument was supported by bankruptcy court's decision in *Loop*, 442 B.R. 713, where court suggested that if guarantors were insolvent, then existence of guaranty might not render claims dissimilar. See *Loop*, 442 B.R. at 724.).

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at *8.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at *9.

⁵² *Id.*

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STUDENT LOANS SHOULD BE DISCHARGEABLE

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The Present Regime

- Student Loan Debt is Non-Dischargeable
 - > All Student Loan Debt-
 - Loans from the Federal Government
 - Loans that were guaranteed by the Federal Government
 - Private Loans

The Present Regime

- Chapter & Verse:
 - > 11 U.S.C. § 523(a)(8) provides:

(B) 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 a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual;

The Present Regime

- ◉ What the heck does “ (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor’s dependents,” mean?

The Present Regime

- ◉ What the heck does “ (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor’s dependents,” mean?
- ◉ Its is so clear it has generated a mere 617 reported decisions!

The Present Regime

- ◉ There is consensus around the Brunner Test:
 - › Debtor must establish she cannot maintain a minimal standard of living based on her current income and expenses if she is required to repay the loans.

The Present Regime

- There is consensus around the Brunner Test:
 - Debtor must establish she cannot maintain a minimal standard of living based on her current income and expenses if she is required to repay the loans.
 - Student Loan Creditor Translation- This means the debtor must prove she lives in abject poverty.*

The Present Regime

- There is consensus around the Brunner Test:
 - Debtor must establish she cannot maintain a minimal standard of living based on her current income and expenses if she is required to repay the loans.
 - Debtor's Translation- Duh! I'm a debtor, if I could afford to pay and maintain my current abject poverty (that allows me to file Chapter 7) I wouldn't have filed BK and definitely wouldn't have shorted my landlord \$200 so I could pay the adversary filing fee.*

The Present Regime

- There is consensus around the Brunner Test:
 - Debtor must establish "additional circumstances" indicate that she will be unable to repay the loans for a significant portion of the repayment period.

The Present Regime

- There is consensus around the Brunner Test:
 - Debtor must establish "additional circumstances" indicate that she will be unable to repay the loans for a significant portion of the repayment period.
 - Student Loan Creditor's Translation: We offer 25-year-income-contingent repayment programs. This repayment scheme would mean \$0.00 per month payments if the Court actually believes the debtor's testimony about her present pathetic circumstances. Ergo the debtor must prove that she will continue to live in abject poverty for the rest of her natural life. Since this is America, and most people eventually get rich, the only debtors that legitimately can prove this are schizophrenic lepers.

The Present Regime

- There is consensus around the Brunner Test:
 - Debtor must establish "additional circumstances" indicate that she will be unable to repay the loans for a significant portion of the repayment period.
 - Debtor's Translation: You have got to be freaking kidding me! Now that the interest I owe is three times what I borrowed, I wouldn't be able to afford this even if I got my dream job. Besides I am a schizophrenic leper!

The Present Regime

- There is consensus around the Brunner Test:
 - Debtor must establish she has made good faith efforts to repay the loans.

The Present Regime

- ◉ There is consensus around the Brunner Test:
 - > Debtor must establish she has made good faith efforts to repay the loans.
 - > Student Loan Creditor's Translation: Even though the debtor made 23 partial payments and we gave forbearances and deferments the rest of the last 15 years, proving this element is metaphysically impossible unless the Debtor has already failed at the 25-year-\$0.00-dollar-per-month income contingent repayment program!

The Present Regime

- ◉ There is consensus around the Brunner Test:
 - > Debtor must establish she has made good faith efforts to repay the loans.
 - > Debtor's Translation: Of course this is in good faith, I made 23 partial payments and obtained forbearances and deferments from the student loan creditor the rest of the last 15 years. Besides I expect to win the power ball next year.

A few facts about student loans generally

- ◉ Student Loan Debt in the United States exceeds \$1 Trillion
- ◉ Student Loan Debt exceeds credit card debt in amount owed.
- ◉ 43% of 25 year olds have student debt with estimates of average balances between \$20,326 and \$25,250.
- ◉ The Federal Government made a \$50.6 Billion profit off of student loans in FY 2012-2013.

A few observations

- There is almost no underwriting of student debt.
- The educational institutions that will be paid tuition and fees from the loans manage the qualification process.
- Generous forbearance and deferment procedures allow students to experience few consequences from borrowing, with little risk to lender.
- Most people pay their debts, including their student loans.
- There is something strange about a culture that starts people out by digging a huge hole for them.

Observations about current nondischargeability regime

- Expensive and inefficient way to deal with major part of consumer credit in the United States.
- Difficult cases to settle because the law leans so heavily in favor of creditor.
- Standard is wildly ambiguous resulting in almost randomly different results.
- Hinders the proverbial fresh start.
- There is a legitimate risk of abuse.

If it were up to me... Federally Backed Student Loans

- Interest, fees, and other charges in excess of original loan disbursed would be dischargeable.
- Debtor would be able to file action to discharge disbursed principal due to undue hardship by (a) debtor could not afford to pay loans and satisfied means test for the majority of the preceding 9 years; or, (b) traditional undue hardship test.
- Loan holder would be able to file to except interest from discharge with presumption of nondischargeability for loans disbursed within 8 years of petition date similar to luxury goods and cash advance presumptions in 523(a)(2)(C) with presumption.

If it were up to me...
Private Student Loans

- ◉ Private loans would be dischargeable.
- ◉ Creditor would have the right to file action under 523 to except amount disbursed from discharge.
- ◉ There would be a presumption of nondischargeability for loans disbursed within 8 years of petition date similar to luxury goods and cash advance presumptions in 523(a)(2)(C) with presumption.

NUMBERS, DRIVERS, AND PROFILES OF STUDENT LOAN DEBT

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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

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

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.

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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*

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.

III. Student Loan Borrowers – Numbers and Profiles

A. Student Loan Debts and Undue Hardship Discharges

To better understand the incidence of education loan debt in bankruptcy, I obtained data from 50 consumer Chapter 7 and Chapter 13 cases filed each year in ten randomly selected jurisdictions from 2004 through 2011.¹ Of the approximately 3,750 cases that I reviewed, 814 reported student loan debt. The table below shows the percentage of cases in which the debtor(s) reported student loan debt for each year, and the average amount of student loan debt per case.

Year	Chapter 7		Chapter 13	
	Percent w/ student debt	Average student loan debt	Percent w/ student debt	Average student loan debt
2004	18.0	\$18,484	14.6	\$13,332
2005	18.9	\$12,545	14.7	\$23,208
2006	19.0	\$16,644	22.2	\$16,304
2007	23.2	\$21,055	22.1	\$21,699
2008	19.9	\$28,213	19.1	\$17,497
2009	21.8	\$29,992	22.0	\$26,908
2010	21.3	\$21,360	24.2	\$24,396
2011	24.3	\$25,096	22.3	\$26,483

There are some anomalous results. For example, there was a significant decline in student debt reported in Chapter 13 cases in 2006. In addition, the amount of debt per case peaked in 2009, the height of the recession. And while it eased back in 2010, by 2011 the average of student loan debt was again on the rise. 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 814 cases with student loan debt, only two Chapter 7 debtors and one 13 Chapter debtor filed adversary proceedings to have their student loans discharged. In a 2009 Chapter 7 case, the debtor obtained 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 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

¹ The jurisdictions include Arkansas Eastern District, Arizona, California Southern District, Georgia Middle District, Indiana Southern District, New York Northern District, Oklahoma, Oregon, Pennsylvania Western District, and Wisconsin Eastern District. Electronic filing was not fully available in Georgia, Indiana, and Wisconsin in 2004, so these jurisdictions were not included for that year. This data is based on amounts reported by debtors on Schedules E (priority unsecured debt) and Schedule F (general unsecured debt). The data presents a general view of student loan debt, and does not purport to be an exact accounting of student loan debt. For example, many student loan debts were listed in round numbers (i.e., \$15,000) whereas the actual amount owed was likely not such a simple number. In addition, as with many debts, debtors may have estimated the amount. Also, the data does not differentiate between debtors filing singly and those filing jointly. Finally, the data adjusts for a statistical anomaly in a 2004 Chapter 7 case.

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

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.

⁴Mary 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).

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 interviewed a number of student loan debtors. Here are a few stories:

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

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).

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 is 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. 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.

**AN INTRODUCTION TO THE FEDERAL
DIRECT CONSOLIDATION LOAN PROGRAM, LOAN
CANCELLATION PROCEDURES AND LOAN FORGIVENESS PROGRAMS**

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**AN INTRODUCTION TO THE FEDERAL
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CANCELLATION PROCEDURES AND LOAN FORGIVENESS PROGRAMS**

Edward M. (“Ted”) King¹

I. Introduction to U.S. Department of Education’s Federal Direct Consolidation Loan Program.

If your clients borrowed money to help pay for their after high school education and they still owe money on these loans, the U.S. Department of Education’s Federal Direct Consolidation Loan Program (Direct Consolidation Loan Program) and Income Based Repayment Plan may help you help them manage their loan repayment and may obviate the need to file a non-dischargeability action to determine the dischargeability of these student loan obligations. The William D. Ford Federal Direct Loan Program (“Direct Loan Program”) was created to give students a less complicated way to consolidate educational loans. Direct consolidation Loans have only one lender to be repaid – the U.S. Department of Education (“ED”).

The Direct Consolidation Loan Program is designed to help borrowers manage and repay the money they borrowed to pay for postsecondary education. A Direct Consolidation Loan allows a borrower to combine one or more federal education loans into a new loan that offers several advantages.

II. Advantages of a Direct Consolidation Loan

A Direct Consolidation loan offers many advantages. Among them:

A. Affordability

By consolidating their education loans, borrowers may be able to extend their loan repayment period. Extending their repayment period reduces borrowers’ monthly payments. However, if it takes longer to repay the loan, the borrower will pay more interest and, therefore, a higher total amount over the life of the loan. Further, consolidation fixes a currently variable interest rate by providing a fixed rate at a weighted average of current loan rates. So to the extent variable rates increased, the consolidated loan’s rate would not rise.

¹ Member, Frost Brown Todd LLC, Louisville, KY. The author is grateful for the assistance of Julie K. Swedback, Senior Attorney, Educational Credit Management Corporation in the preparation of these materials and his remarks.

B. Flexibility

When borrowers consolidate their loans, they gain financial flexibility. They can choose from several different repayment plans and change their repayment plan as financial circumstances change. They pick the plan that best fits their needs.

C. Efficiency

A Direct Consolidation Loan also permits borrowers to consolidate loans from different lenders. If they have different types of loans (subsidized and unsubsidized student loans), they may consolidate all of them into a single consolidation loan. The borrowers will receive only one monthly bill.

There are no loan fees charged, and there are no minimum or maximum loan amounts in the Direct Consolidation Loan Program.

D. Convenience

By consolidating their education loans, borrowers simplify their loan communication requirements. They will have only one place to send their monthly payment and only one phone call to report a change of address or phone number, request a deferment, or ask a question about their loan(s).

E. Deferral and Forbearance Options

Borrowers who consolidate their loans into the Direct Consolidation Loans again become eligible for deferments and forbearances, even if their current loans are defaulted.

F. Public Service Loan Forgiveness Program Eligibility; Servicemember Benefits

Borrowers who consolidate with Direct Consolidation Loans are eligible for the Public Service Loan Forgiveness Program. Further, members of the armed services may receive a reduced interest rate or no accrual of interest during periods of qualifying active duty military service.

III. Consolidating Defaulted Student Loans

If the borrower is in default in the Federal Family Education Loan Program (“FFELP”), the borrower can consolidate the loan into any of the Ford’s Program’s payment options including the Income Contingent Repayment Program (the “ICRP”) or the Income Based Repayment Program (the “IBR”).

Collection costs on currently defaulted FFELP loans are reduced to 18.5% of the principal and interest balance on loans that are consolidated into the Ford Program. Under current regulations, this could mean a savings of 6.5% on the total loan amount.

Note:

- If a judgment has been issued, the judgment must be released.
- If, before applying for consolidation, borrowers want to completely clear the default notation on from their credit record, they may want to consider another option – loan rehabilitation.

IV. Repayment of Direct Consolidation Loans

A. First Payment

The first payment on a Direct Consolidation Loan will be due within 60 days of the first disbursement.

B. Payment Period

The length of time a Direct Consolidation Loan will be in repayment will vary depending on the total amount of the loans and the repayment plan a borrower selects.

C. Prepayment

A borrower may prepay all or any portion of a Direct Consolidation Loan at any time without penalty.

V. Repayment Options

In most cases, a borrower may chose to repay a Direct Consolidation Loan through one of four repayment plans:

A. Standard Repayment Plan

B. Extended Repayment Plan

C. Graduated Repayment Plan

D. Income Contingent Repayment Plan

Note: PLUS Loans are now eligible for repayment under the ICRP

If a repayment plan is not selected, the Direct Consolidation Loan will be placed on the Standard Repayment plan.

Borrowers who believe that none of the available plans are feasible may petition the Secretary of Education for an alternative repayment plan.

E. Income-Based Repayment Plan

VI. Some Distinguishing Factors and a Summary of the Plans

A. Length of Repayment

1. Standard Repayment Plan – Up to 30 years, depending on the loan balance
2. Extended Repayment Plan – 12-30, depending on the loan balance.
3. Graduated Repayment Plan – 12-30 years, depending on the loan balance.
4. Income Contingent Repayment Plan – Up to 25 Years
5. Income-Based Repayment Plan – Up to 25 Years

B. Standard Repayment Plan

With standard repayment, borrowers make a fixed payment of at least \$50 a month for up to 30 years. For some borrowers, this plan results in the lowest total amount of interest paid because the repayment period is shorter than it would be under the other plans. In general, the shorter the repayment period, the lower the total interest payment.

C. Extended Repayment Plan

With extended repayment borrowers make fixed payments of at least \$50 a month over a period that varies from 12 to 30 years, depending on the total amount of their Direct Consolidation Loan and other allowable education loans.

Because the borrower will take more than 10 years to repay the loan under the extended plan, the monthly payment will be less than under the Standard Repayment Plan. However, the total amount they paid will be greater because they pay more interest.

D. Graduated Repayment Plan

With graduated repayment, payments start out low, then increase, generally every two years. The length of the repayment period will vary from 12 to 30 years and depends on the total amount of the Direct Consolidation Loan and other allowable education loans.

This plan might be right for borrowers who expect their income to increase steadily over time. The minimum monthly payment will be the greater of the interest that accumulates on the loan between payments, or half of the payment the borrower would make each month under the Standard Repayment plan. However, the monthly payments will never be more than one-and-one-half times what the borrower would pay under standard repayment. Generally, the amount a borrower will repay over the term of his or her loan will be higher under graduated repayment than under extended repayment. However, graduated repayment has the advantage of offering lower payments earlier in the borrower's career where income may be lower.

E. Income Contingent Repayment Plan

1. General

With the ICRP, a borrower's monthly payments will be calculated on the basis of his annual income and the total amount of his Direct Loans.

2. Parental PLUS Loans Eligible. Recently, the Department of Education changed its longstanding policy that prohibited consolidation of Parental Loans for Undergraduate Students ("PLUS Loans") into the ICRP. This meant that a parent could not consolidate loans into the ICRP and then retire and have a minimal adjusted gross income and thereby a minimal monthly payment. However, this policy is no longer in effect and this is a great benefit for borrowers who have PLUS Loans.

3. Capitalization of Interest

If the payments are not large enough to cover the interest that has accumulated on a borrower's loans, the unpaid interest will be capitalized once each year. This means that the unpaid interest will be added to the principal owed. If capitalization increases the total amount owed to 10 percent more than the original amount owed when the borrower entered repayment, interest will continue to accumulate but will no longer be capitalized.

4. Repayment Period/Cancellation of Balance

The maximum repayment period is 25 years. This is the important part: if the borrower hasn't fully repaid his loans after 25 years under this plan, the unpaid portion will be cancelled. However, the borrower may have cancellation of indebtedness income on the amount that is cancelled.

Under this plan the borrower will pay an amount based on the Adjusted Gross Income ("AGI") his household reports on his federal tax return. If he is married, the amount he pays will be based on his income and his spouse's income.

5. Payment Amounts Based on "Discretionary Income"

The amount a borrower will pay will never be greater than 20 percent of his discretionary income. This is AGI minus the poverty level for his family size. The required payment amount will actually be the lesser of (a) 20% of Discretionary Income and (b) the amount the borrower would repay annually over 12 years using a standard amortization multiplied by an income percentage factor that varies with the borrower's AGI.

6. Treatment of Spouse's Income.

The income of a borrower's spouse will always be counted in the AGI calculation, whether or not the spouse files jointly with the borrower or separately.

7. Discretionary Income = AGI – Poverty Level for Family Size

8. Interest Rate is Weighted Average.

A borrower's interest rate for a direct consolidation loan is based on the weighted average of all loans consolidated.

9. Alternative Documentation of Income

A borrower will be required to submit alternative documentation of his current income (that is, other than IRS-reported AGI) to the Department of Education. Such documentation includes pay stubs, canceled checks, or, if these are unavailable, a signed statement explaining the borrower's income sources. The form also has a box to check if the borrower has no taxable income and/or does not file a tax return.

In addition, a borrower may choose to submit alternative documentation of current income if special circumstances, such as loss of employment for the borrower or his spouse, warrant an adjustment to his monthly payment.

11. Payment Calculator; Payment Amounts

A great payment calculator for the ICRP can be found at:

https://loanconsolidation.ed.gov/loancalc/servlet/Controller?controller_task=startCalculator

It shows the total monthly payment and even shows the total payments throughout the term of the loan so that borrowers can see whether there is some forgiveness of their loan balance if they pay for the 25 year period and there is a balance left.

If a borrower's income is less than or equal to the poverty level for his family size, his monthly payment will be zero. If a borrower's calculated monthly payment is greater than zero but less than \$5, he will be required to make a \$5 monthly payment.

F. Income-Based Repayment Plan.

1. General

Like the ICRP, a borrower's monthly payments under the Income-Based Repayment Plan will be calculated on the basis of his annual income and the total amount of his Direct Loans.

To qualify for the IBR, borrowers must first demonstrate partial financial hardship. Borrowers can demonstrate partial financial hardship if the annual amount due on all eligible student loans under a 10-year repayment schedule is more than 15% of their adjusted gross income minus 150% of the federal poverty guideline for the applicable family size. Most borrowers whose total loan balance exceeds their annual earnings will satisfy the partial financial hardship requirement

2. Treatment of Married Borrowers Filing Separately

With the Income-Based Repayment Program, the income of a non-borrower spouse who files a separate income tax return is not counted in the calculation of AGI but the non-borrower spouse is still counted in the family size. This can be a great benefit to low

to moderate income borrowers with higher income spouses who can afford to file separately.

3. Capitalization of Interest

Same as ICRP

4. Repayment Period/Cancellation of Balance

Same as ICRP. However, Congress passed legislation in 2010 that applies to IBR loans taken out after July 1, 2014. For those loans, the maximum repayment period (and the period after which the loan would be cancelled) is only 20 years, rather than 25.

Under this plan the borrower will pay an amount based on the Adjusted Gross Income (AGI) his household reports on his federal tax return. If he is married filing jointly, the amount he pays will be based on household income. If his spouse also has federal student loan debt, the IBR payment based on household income will be prorated over the set of loans. But if he is married filing separately, he may still count his spouse and any dependents in the calculation of family size, but the IBR amount he pays will be based only on his income and the IBR payment will be applied to his loan only.

5. Payment Amounts Based on “Discretionary Income”

The amount a borrower will pay will never be greater than 15 percent of his discretionary income. This is AGI minus 1.5 times the poverty level for his family size. This often results in a lower payment than under the ICRP, which is 20 percent of AGI minus the poverty level for the family size. And family size includes the spouse, whether or not the spouse files a joint return.

The 2010 legislation described above regarding the 20 year repayment period also lowers the percentage of discretionary income that must be paid towards the loan from 15 percent to 10 percent.

6. Discretionary Income = AGI – (1.5 x Poverty Level for Family Size)

7. Payment Calculator; Payment Amounts

A great payment calculator for the IBR can be found at:

https://loanconsolidation.ed.gov/loancalc/servlet/Controller?controller_task=startCalculator

If a borrower's income is less than or equal to the poverty level for his family size, his monthly payment will be zero. If a borrower's calculated monthly payment is greater than zero but less than \$5, he will be required to make a \$5 monthly payment. If it is more than \$5 but less than \$10, it will be a \$10 monthly payment.

VII. Certain Loan Cancellation Procedures and Loan Forgiveness Programs. Student loan borrowers must repay their loans even if they do not complete their education, cannot find a job related to their program of study, or are unhappy with the education they paid for with your loan. However, certain circumstances might lead to loans being forgiven, canceled, or discharged.

A. Total and Permanent Disability Cancellation.

1. Generally. Borrowers may be eligible for a TPD Discharge on their federal student loans if they are unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that (a) can be expected to result in death,(b) has lasted for a continuous period of not less than 60 months, (c) can be expected to last for a continuous period of not less than 60 months; or (d) has been determined by the Secretary of Veterans Affairs to make them unemployable due to a service-connected disability.

2. Conditional Discharge and Monitoring Period. If the application is approved, a discharge is granted and the borrower is then subject to a 3-year post-discharge monitoring period. During this monitoring period, the borrower (a) must not have annual employment earnings that exceed the Poverty Guidelines for a family of two in the borrower's state; (b) must not receive a new Perkins, or Direct Loan or a new TEACH Grant; and (c) must ensure the return of a loan disbursement made before the discharge date, but was disbursed during the 3-year post-discharge monitoring period.

3. For More Information and for an Application.
<http://www.disabilitydischarge.com>

B. Death Discharge.

C. Closed School Discharge.

1. Eligibility. A borrower may be eligible for discharge of federal loans under any of the following circumstances: (a) the school closes while the student was enrolled and the student does not complete the program because of the closure or (b) the school closes within 90 days after the student withdrew.

2. Ineligibility. The borrower may not receive a discharge if her school closes and either (a) she withdrew more than 90 days before the school closes, (b) she is completing a comparable educational program at another school, or (c) she has completed all of the coursework for the program but has not received a diploma or certificate.

D. False Certification of Student Eligibility or Unauthorized Payment Discharge. A borrower may be eligible for a discharge if (1) the borrower's school falsely certified the student's eligibility based on the student's ability to benefit from the school's training and the student did not meet the ability to benefit student eligibility requirements, (2) the school signed the student's name on the application or promissory note without the borrower's authorization or endorsement the school loan check or signed the student's authorization for electronic funds transfer without the student's knowledge, (3) the loan was falsely certified because the student was a victim of identity theft, (4) the school certified the student's eligibility but because of a physical or mental condition, age, criminal record, or other reason, the student is disqualified from employment in the occupation in which the student was being trained.

E. Teacher Loan Forgiveness. Certain borrowers with federal student loans who have been teaching full-time in a low-income elementary or secondary school or educational service agency for five consecutive years, you may be able to have as much as \$17,500 of their subsidized or unsubsidized loans forgiven.

F. Public Service Loan Forgiveness. Borrowers who make 120 qualifying payments under the IBR, ICR, or 10-year fixed payment schedule while employed in the public sector are eligible to have any balance remaining on their student loan debt forgiven. Public service includes employment with most local, state, federal, tribal, or § 501(c)(3) corporations. There is specific language in this regulation that exempts any forgiven debt from constituting a taxable event. (Ford Program loans only).

G. Alternative Payment Arrangements. Borrowers who believe that none of the payment options are suitable may request an alternative repayment plan from the Secretary of Education. *See* 34 C.F.R. § 685.208(g).

H. Suspension of Payments: In addition to the different types of repayment plans, borrowers may seek deferment of repayment or forbearance. During a deferment period, no interest accrues on subsidized loans but interest continues to accrue on unsubsidized loans. The borrower may pay the interest or have it added to the principal when the deferment expires. Forbearance postpones or reduces the monthly repayment for a limited, specific period, during which interest on the loans accrues. If the interest is not paid, it is added to the principal balance. Forbearance may be granted based upon a borrower's poor health, temporary financial hardship, if the borrower is obligated to make payments on federal student loans that are equal to or greater than 20% of monthly gross income, or other reasons acceptable to ED.

VIII. Additional Resources

National Consumer Law Center, *Student Loan Law: Collections, Intercepts, Deferments, Discharges, Repayment Plans, and Trade School Abuses* (2d ed. 2002).

David J. Light, Esq., *Discharging Student Loans in Bankruptcy* (2d ed. 1999).

IX. Web Sites

Federal Student Aid (government website): (<http://studentaid.ed.gov>)

Finaid (consumer financial aid website): (www.finaid.org)

Department of Education (www.ed.gov)

Department of Education Ombudsman Office (www.ombudsman.ed.gov)

William D. Ford Direct Loan Program (www.loanconsolidation.ed.gov)

National Student Loan Data System (www.nsls.ed.gov)

ED PIN website: (www.pin.ed.gov)

National Counsel of Higher Education Loan Programs (www.nchelp.org)

Educational Credit Management Corporation (www.ecmc.org)

FFEL Forms: (<http://www.ecmc.org/topic/mainForms.html>)

Direct Loan (Ford program) Forms: (<https://www.dl.ed.gov/borrower>)

Should Chapter 13 Plans Discharge Student Loans?

Journal Article:

The Tenth Circuit Bankruptcy Appellate Panel's (BAP) recent decision in *In re Mersmann*, 318 B.R. 537 (10th BAP 2004), underscores the continuing tension between chapter 13 plan provisions discharging student loans, and implies that such discharge provisions are contrary to law and should not be enforceable.² Courts considering the issue have either focused on the *res judicata* effect of confirmed chapter 13 plans and the finality of orders, or have found such plan discharge provisions contrary to due process requirements and unenforceable.³ Debtors argue that the need to effectuate the fresh-start concept of bankruptcy overrides any procedural due process that creditors are entitled to. Educational lenders, whether private or governmental, decry such provisions as contrary to the pleading requirements of civil suits—the necessity of a summons and complaint—and at odds with 11 U.S.C. §523(b)(8)'s mandate that the debtor must prove undue hardship before obtaining a discharge of a student loan. By including discharge provisions in chapter 13 plans, consumer lawyers use the chapter 13 plan process to circumvent the weight of authority, making student loans difficult to discharge by employing a streamlined process of plan confirmation to achieve a beneficial result to debtors.

Background

11 U.S.C. §523(a)(8) formerly provided that a student loan would not be discharged unless it “became due more than seven years (exclusive of any applicable suspension of the repayment period) before the date of the filing of the petition....” “In the alternative, if the loan was less than seven years due, the debtor could discharge the student loan if “excepting such debt from discharge under this paragraph will impose an undue hardship on the debtor and the debtor's dependents....” 11 U.S.C. §523(a)(8).

On Oct. 7, 1998, President Clinton signed the Higher Education Amendments of 1998 (1998 HEA), which provided federal funding for education loans at a reduced rate of interest. Section 971 of the 1998 HEA eliminated the automatic seven-year discharge requirement of §523(a)(8). In addition, §484 of the 1998 HEA provided that the United States may register a state court judgment for an unpaid student loan in federal district court by filing a certified copy of the judgment and a copy of the assignment or transfer. As such, the United States no longer has to file a complaint to secure a separate judgment for an unpaid student loan that has been adjudicated by a state court. As a result, student loans can no longer be discharged because of the age of the obligation.⁴ Debtors⁵ have to file dischargeability complaints to contest the dischargeability of the student loans as being an undue hardship on the debtor and/or the debtor's dependents (absent provisions in a confirmed chapter 13 plan to the contrary).

The elimination of the seven-year discharge provision does suggest, however, that Congress now views “undue hardship” not as a *debtor* protection, but rather as a *creditor* protection. Consequently, fresh start should no longer be the issue, but rather whether the non-payment of the student loans violates public policy. The bar to having a student loan discharged has been raised, and the circumstances that warranted an undue-hardship discharge are more onerous than previously considered.

After the 1998 HEA amendments, several courts grappled with the harsh consequences of an “all-or-nothing” approach to the discharge of student loans. In an effort to make student loan discharge decisions more equitable and to effectuate the notion of a fresh start, a number of courts adopted a partial discharge of student loans premised on the debtor's ability to pay. These courts theorized that having debtors repay their loans on the basis of ability to pay tempered the creditor's need to obtain some payment on a non-dischargeable debt with the need to provide providing debtors with some finality in the payment of their student loans.

For example, in *Tennessee Student Assistance Corp. v. Hornsby (In re Hornsby)*, 144 F.3d 433, 439 (6th Cir. 1998), the court concluded that an «all-or-nothing treatment [of student loans] thwarts the purpose of the Bankruptcy Act.» The Sixth Circuit believed that the equitable powers of the bankruptcy court (11 U.S.C. §105(a)) trump Congress's overriding directive that student loans should not be discharged. *Id.* at 440. The *Hornsby* court found that the harshness of an «all-or-nothing» approach contradicts the principal objective of bankruptcy, which is the fresh start. As such, the Sixth Circuit reasoned that a partial discharge preserves the objectives of requiring some repayment of student loans while affording the debtor a chance of having a true fresh start. *Id.*

The Ninth Circuit adopted the use of a partial discharge in *Graves v. Myrvang (In re Myrvang)*, 232 F.3d 1116 (9th Cir. 2000), and found that §105 allows a court to grant a partial discharge in a debt arising out of a divorce decree. *Id.* at 1123-24; 11 U.S.C. §523(a)(15). The *Myrvang* court held that a total discharge or «all-or-nothing» approach to discharge thwarts the purpose of the Bankruptcy Code, which is the adjustment of the creditor/debtor relationship in achieving a fresh start. *Myrvang* also held that the court's analysis under §523(a)(15) would equally apply under §523(a)(8). *See, also, Saxman v. Dept. of Educ. et al. (In re Saxman)*, 263 B.R. 342, 345 (W.D. Wash. 2001).

The Sixth and Ninth Circuit Court of Appeals hold that the equitable powers of §105 provide bankruptcy courts with the authority to effect partial discharges of student loans where full repayment of all the debt would be an undue hardship. *Hornsby*, 144 F.3d at 440; *Griffen v. Eduserv (In re Griffen)*, 197 B.R. 144, 147 (Bankr. E.D. Okla. 1996).

Section 105(a)—the “equitable powers” of the bankruptcy court—has on many occasions been invoked to allow a bankruptcy court the means to effectuate a decision that otherwise would not be supported under statutory construction. Section 105(a) authorizes the bankruptcy court to fashion such orders as are required to further the substantive provisions of the Code. It gives the bankruptcy court general equitable powers; however, these powers may only be used in a manner consistent with the Code. *Young v. PHEAA (In re Young)*, 225 B.R. 312, 317 (Bankr. E.D. Pa. 1998). However, §105 does not give the bankruptcy courts the power to create substantive rights that would not be available under the Code. *Id.*; *Peel v. Sallie Mae, et al. (In re Peel)*, 240 B.R. 387 (Bankr. N.D. Cal. 1999).

The preceding discussion evidences a progression in some courts to weaken, if not alter, the effect of §523(a)(8). The use of a confirmed plan to discharge student loans, even with proper notice to the student loan creditor, is yet one further attempt to limit the debtor's obligations to repay money lent in furtherance of the debtor's education. Curiously, since 1998, Congress has not evidenced a similar attitude toward the non-payment of student loans. In fact, during the ongoing debate to “reform” the Bankruptcy Code, there has been little interest in Congress to abrogate a debtor's obligation to pay his/her student loans.

In re Mersmann

The Tenth Circuit BAP's decision in *Mersmann* is both symbolic and representative of the current debate on chapter 13 provisions discharging student loans. In *Mersmann*, the debtor clearly and unequivocally stated that upon completion of payment of 10 percent to all general unsecured creditors under the plan, all unsecured general debts, including school loans that are non-dischargeable in chapter 7 cases, shall be discharged. *Mersmann*, 318 B.R. at 539.⁸ Several months later, the debtor amended the plan to include the following language:

School loans that are non-dischargeable in chapter 7 case—to be treated as general unsecured creditors... Upon completion of plan and payment of said 10 percent of allowed general, unsecured creditors, all remaining unsecured debts, including school loans that are non-dischargeable in chapter 7 cases, shall be discharged. *Said completion of the plan shall result in a finding that it would be an undue hardship for the debtor to have to pay any additional monies to the*

special class of school loans not otherwise dischargeable. *Id.* at 539 (emphasis added).

The *Mersmann* court noted the impact of the amended plan provision: The debtor sought an express finding that payment of the student loan would be an undue hardship. *Id.* at 540. The creditor did not object to the original plan or the amended plan. *Id.* Years later, and several months after discharge, the creditor recognized its dilemma and filed a motion to amend the confirmation order and amended plan under F.R.C.P. 60(b). The bankruptcy court denied the motion.⁷

The Tenth Circuit BAP acknowledged that the procedures for obtaining a student loan discharge required the filing of a complaint and summons and seeking court adjudication on the issue of undue hardship to pay the student loan. That said, the *Mersmann* court was constrained to follow the Tenth Circuit's prior ruling in *Andersen v. UNIPAC-NEBHELP (In re Andersen)*, 179 F.3d 1253 (10th Cir. 1999), wherein the court upheld a similar plan provision regarding a finding of undue hardship under principles of *res judicata* and policies favoring the finality of confirmation orders. *Id.* at 541. Like *Mersmann*, the debtor in *Andersen* did not establish undue hardship in an adversary proceeding. *Id.* Moreover, the *Mersmann* court recognized that in situations (like *Andersen*) where a chapter 13 plan has a specific finding of undue hardship, the court must allow the language to stand. *Id.*⁸

The *Mersmann* court maintained that a creditor must be vigilant in monitoring plan provisions involving a finding of undue hardship to protect its interests. *Id.* Moreover, the creditor's obligation to be vigilant cannot be delegated to the bankruptcy court or chapter 13 trustee. *Id.*, citing *In re Szostek*, 866 F.2d 1405, 1414 (3rd Cir. 1989). In addition, the BAP found that after the plan is confirmed, the policy favoring the finality of confirmation orders is stronger than the court's and trustee's obligation to verify Code compliance. *Id.* (citation omitted). The *Mersmann* court noted that the necessity of the filing of a summons and complaint, and the need for due process, was abrogated by the creditor's failure to object to the confirmed plan and amended plan. *Id.* at 544. While the court agreed with the creditor's argument that a summons and complaint is necessary in discharging a student loan, the holding of *Andersen* required the court to determine that the student loan had been discharged by the confirmed and amended plan. *Id.* Moreover, had the creditor in *Mersmann* been the United States, it is questionable that the order confirming plan could have survived an argument under F.R.C.P. 55(e). Under Rule 55(e), a party cannot take a default (*i.e.*, the failure to answer or respond) against the United States without first establishing that the claimant has a claim or right to relief by evidence satisfactory to the court.

Why the Courts Are Wrong in Upholding Such Plan Provisions

The analysis in support of chapter 13 plans that contain a finding of undue hardship has become a familiar one. Courts rationalize their holdings on at least three arguments: *res judicata*, the finality of confirmation orders and the need of a fresh start. While there is merit to each position, each position is not without challenge. For example, many courts maintain that a chapter 13 plan should have *res judicata* effect. Yet there have been some courts that recognize that the finality of a chapter 13 plan is not absolute. For example, the Fourth Circuit found that a creditor's lien cannot be avoided by merely listing the secured claim as unsecured and not providing for the continued existence of the lien in a chapter 13 plan. *Cen-Pen Corp. v. Hanson (In re Hanson)*, 58 F.3d 89 (4th Cir. 1995); accord, *In re Holloway*, 261 B.R. 490 (M.D. Ala. 2001) (liens not provided for in chapter 12 plan will not be extinguished upon confirmation).

Hanson involved a chapter 13 plan that treated a lien on the primary residence as unsecured. The creditor did not object to the confirmation of the Hansons' chapter 13 plan or file a secured proof of claim. *Hanson*, 58 F.3d at 91. Further, the confirmed chapter 13 plan provided that "to the extent that the holder of a secured claim does not file a proof of claim, the lien of such creditor shall be avoided upon the entry of the order of discharge...." *Id.* at 92. The debtors subsequently received their discharge and filed a complaint in bankruptcy court to avoid the creditor's lien, arguing that it had been discharged by the order confirming plan. *Id.*

The bankruptcy court agreed with the debtors that the lien was discharged by operation of the order confirming plan. The district court reversed, finding that confirmation of the plan vested in the debtors the same interest in the residence that they had before filing bankruptcy—a residence subject to a lien. *Id.*

The Fourth Circuit declined to follow the debtors' argument that confirmation of the debtors' plan under §1327 is *res judicata* as to the validity of a lien. *Id.* In addition, the Fourth Circuit held that «[f]or a debtor to extinguish or modify a lien during the bankruptcy process, some affirmative step must be taken toward that end.” *Id.* (citation omitted). Further, «[t]he simple expedient of passing their residence through the bankruptcy estate could not vest in the Hansons a greater interest in the residence than they enjoyed prior to filing their chapter 13 petition.” *Id.* at 93. The Fourth Circuit recognized that the validity of a lien can only be raised in the context of an adversary proceeding. *Id.*

In *Campbell v. Eastland*, 307 F.2d 478 (5th Cir.), *cert. denied*, 513 U.S. 905 (1962), the Fifth Circuit found that Rule 55(e) rests on the rationale that the taxpayers should not have to bear the burden of a windfall awarded against the government. The Fifth Circuit also found that a claimant should not be relieved of proving the elements of its claim without requisite proof. *Id.* As a result, Rule 55(e) affords the United States a substantial protection against judgments for baseless claims. *Id.* As such, where the government fails to act, the ability of the debtor to avoid the protections of Rule 55(e) comes into play.

Second, many courts have focused on the finality of orders confirming plans. A plan can still be final, and provide for only partial repayment of a student loan, but not provide a debtor with an adjudication of undue hardship without proving same. The debtor can also retain the right to contest liability through an adversary proceeding. This would be no different than if the debtor's plan provided for the discharge of a valid finding of discrimination against the debtor or that the debtor had violated an environmental regulation.

Finally, many courts maintain that a debtor must obtain a “fresh start.” While this is true, Congress obviously recognized in §523 that there are a number of obligations or debts that by either their nature or on policy grounds should not be discharged. In many instances, §523 exceptions to discharge are either deemed non-dischargeable or must be contested through an adversary proceeding. The use of a plan provision to discharge an otherwise non-dischargeable debt defeats congressional intent.

Footnotes

¹ The views expressed in this article are Mr. Gargotta's and do not necessarily reflect the views of the Department of Justice or Department of Education.

² See *Great Lakes Higher Educ. Corp. v. Pardee (In re Pardee)*, 193 F.3d 1083 (9th Cir. 1999) (discharging student loan); *Banks v. Sallie Mae Corp. (In re Banks)*, 299 F.3d 296 (4th Cir. 2002) (refusing to discharge student loan).

³ Cf. *Education Credit Management Corp. v. Whelton (In re Whelton)*, 299 B.R. 306 (Bankr. D. Vt. 2003), *aff'd.*, 312 B.R. 508 (D. Vt. 2004) (summons and complaint necessary to satisfy creditor's due process rights); *In re Ruehle*, 296 B.R. 146 (Bankr. N.D. Ohio 2003), *aff'd.*, 307 B.R. 28 (6th BAP 2004) (due process requires a summons and complaint, and the rule is no less clear for student loans); *In re Lemons*, 285 B.R. 327 (Bankr. W.D. Okla. 2002) (such plan provisions are sanctionable); *with Andersen v. UNIPAC (In re Anderson)*, 179 F.3d 1253 (10th Cir. 1999) (finality of confirmation order more important than legality of provision).

⁴ The statute of limitations regarding the collection of student loans was eliminated in 1991 to remove any statute of limitations for collecting on student loans. 20 U.S.C. §1091a(a); *see, e.g., United States v. Phillips*, 20 F.3d 1005 (9th Cir. 1994); *United States v. Hodges*, 999 F.2d 341 (8th Cir. 1993).

⁵ The burden of proof to show undue hardship is clearly on the debtor. *Bachner v. Illinois (In re Bachner)*, 165 B.R. 875, 880 (Bankr. N.D. Ill. 1994); *Evans v. Higher Education Assistance Foundation (In re Evans)*, 131 B.R. 372, 374 (Bankr. S.D. Ohio 1991).

⁶ The use of the language «that are non-dischargeable in chapter 7 cases» is noteworthy in that student loans by statute are non-dischargeable in chapter 13 cases. *See* 11 U.S.C. §1328(a)(2).

⁷ In fact, the bankruptcy court considered three other chapter 13 plans involving similar plan provisions. *Mersmann* at 540, n.8.

⁸ Compare the Tenth Circuit's holding in *Poland v. Educational Credit Management Corp. (In re Poland)*, 382 F.3d 1185 (10th Cir. 2004), wherein the court found that absent a specific finding of undue hardship in a confirmed plan, a plan provision discharging a student loan is not binding.

**THE STUDENT LOAN QUANDARY:
WHY ELIMINATING THE
BANKRUPTCY DISCHARGE EXCEPTION IS NOT THE ANSWER**

AUGUST 23, 2013

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THE STUDENT LOAN QUANDARY

I. Student Loans Should Remain Presumptively Non-Dischargeable in Bankruptcy¹

Now that the collapse of the housing market is old news, there is a fresh crisis for the media and public to embrace -- the student loan industry. Americans have, collectively speaking, more student loan debt than credit card debt.² The ubiquitous stories about high student loan payments, continual sluggishness in the economy, the eye-popping annual increases in tuition at public universities across the country, the exponential growth of for-profit trade schools, and the continued globalization of commerce have some critics saying “enough already.” In fact, many critics have concluded that the best way to resolve the “student loan problem” is to make student loans dischargeable in bankruptcy.

Congress has decided that legislation is needed to prevent a reduction in consumer spending caused by the “student loan problem.” To assist young Americans saddled with student loan payments, Congress is contemplating legislation that would provide relief to approximately 37 million borrowers, or roughly 12% of the population. One such solution involves amending Section 523(a)(8) of the Bankruptcy Code to make it easier to obtain a discharge of student loan debt in bankruptcy. Others cry for the outright elimination of Section 523(a)(8). As discussed below, eliminating the exception of student loans from bankruptcy discharge is not the solution.

II. The Ubiquitous Presence of Student Loans

It is no secret that millions of students in the United States are grappling with managing their student loan debt. It is estimated that there is over \$1 trillion in total outstanding student loan debt in the United States today.³ The average student loan balance is close to \$25,000; over

¹ Grateful acknowledgement is made to Julie K. Swedback, Senior Attorney at Educational Credit Management Corporation, for the generous assistance and valuable written information she provided in the preparation of these materials.

² http://www.washingtonpost.com/blogs/college-inc/post/student-loans-surpass-auto-credit-card-debt/2012/03/06/gIQARFQnuR_blog.html

³ See Donghoon Lee, *Household Debt and Credit: Student Debt* at 2 (Federal Reserve Bank of New York, Feb. 28, 2013), http://newyorkfed.org/newsevents/mediaadvisory/2013/Lee_022813.pdf.

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12 percent of borrowers owe \$50,000 or more.⁴ Of the approximately \$1 trillion in student loan debt, approximately \$85 billion is past due.⁵

A. An Overview of the Student Loan Industry

Few dispute that higher education provides a path for many to attain financial prosperity.⁶ Indeed, in 2012, the median weekly earnings of those with a professional degree exceeded those with a high school diploma by \$1,083.⁷ In recognition of the benefits of higher education, Congress devised a federal student loan program in 1965, under which loans were made available to students who may otherwise not be able to receive adequate financing for their educational aspirations.⁸ That year, Congress passed the Higher Education Act of 1965. The purpose was to provide funds for a college education to all students of ability, regardless of their socio-economic background.

Several years after the Higher Education Act was enacted, Congress realized that student loan debtors had filed bankruptcy petitions in record numbers, and had walked away from their responsibility to repay their federally guaranteed debt. In response to the increased filings, and in an effort to preserve the financial viability of the federal student loan program and to protect the bankruptcy process from abuse, Congress enacted Section 523(a)(8) of the Bankruptcy Code as part of the Bankruptcy Reform Act of 1978.⁹

There is a narrow list of categories of debts for which debtors remain liable even after bankruptcy. Separate important public policy reasons underlie each of the exceptions to

⁴ *Id.*

⁵ *Id.*

⁶ *In re Roberson*, 999 F.2d 1132, 1136 (7th Cir. 1993).

⁷ http://data.bls.gov/cgi-bin/print.pl/emp/ep_chart_001.htm.

⁸ *Higher Education Act of 1965, H.R. 621, 89th Cong., 1st Sess. (1965); Higher Education Act of 1965, S.673, 89th Cong., 1st Sess. (1965); Higher Education Act of 1965, Pub. L. No. 89-329 (1965); Vol. 111 Cong. Record (1965) 883, 978, 17367* (signed into law on November 8, 1965 “to strengthen the educational resources of our colleges and universities and to provide financial assistance for students in postsecondary and higher education”).

⁹ *Pub. L. No. 95-598, 92 Stat 2549 et seq. (1978); In re Pelkowski*, 990 F.2d 737, 743 (3d Cir. 1993).

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discharge. The legislative history of Section 523(a)(8) makes clear that Congress afforded special protection to student loans in bankruptcy because of their unique nature and the potential for abuse of the student loan program absent such special protection. As comments from the legislative history explain,

[e]ducational loans are different from most loans. They are made without business considerations, without security, without cosigners, and rely for repayment solely on the debtor's future increased income resulting from the education. In this sense, the loan is viewed as a mortgage on the debtor's future.¹⁰

While some have painted this exception to discharge as draconian, the exception is simply in recognition that in making these loans, the government (initially as guarantor and now as a direct lender) is:

unable to behave like ordinary commercial lenders, who may, after investigating their borrowers' financial status and prospects, choose to deny as well as grant credit and may adjust the interest rate which they charge according to their judgment as to the likelihood of repayment. The government has no such luxury. It offers loans at a fixed rate of interest, and does so almost without regard for credit-worthiness.¹¹

Since its enactment, Section 523(a)(8) has undergone several amendments. While Congress has added new programs, streamlined existing programs, and increased authorized funding levels, each amendment has also made it progressively harder for a student to discharge his or her student loans. Currently, the statute permits student loans to be discharged only on a showing of undue hardship. As the Court of Appeals for the Eleventh Circuit recognized, the current statute reflects "Congress' intent to make it harder for a student to shift his debt responsibility onto the taxpayer."¹²

¹⁰ H.R. Rep. No. 595, 95th Cong., 1st Sess. 133 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6094.

¹¹ *Brunner v. New York State Higher Educ. Services (In re Brunner)*, 46 B.R. 752, 756 (S.D.N.Y. 1985), *aff'd* 831 F.2d 395 (2d Cir. 1987).

¹² *Hemar Ins. Corp. v. Cox (In re Cox)*, 338 F.3d 1238, 1242 (11th Cir. 2003).

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B. Federally Backed Loans vs. Private Loans

Prior to the 2005 BAPCPA amendments, only federally backed loans were non-dischargeable. Now, private loans may also qualify under 523(a)(8)(B) if they constitute a “qualified education loan” as defined in Section 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.” These IRC terms are very technical and further analysis of the loans that *do not* meet this definition of student loans is outside the scope of this brief outline. However, given the myriad of “loan products” now available to students, more loans may fail to qualify for presumptive non-dischargeability under Section 523(a)(8) than assumed.

III. The Link Between Education and Future Earnings

Despite the burden associated with financing the education of our future leaders, it is widely known that education is highly valued in today’s society. Education is arguably more important today than it was 30 years ago. As of 2012, over 30% of the United States population over the age of 18 had a bachelor’s degree, compared to only 17% in 1983.¹³ More surprisingly, for young adults between the ages of 25 and 29, the percentage of high school graduates was roughly 50% in 1950 versus 90% today.¹⁴

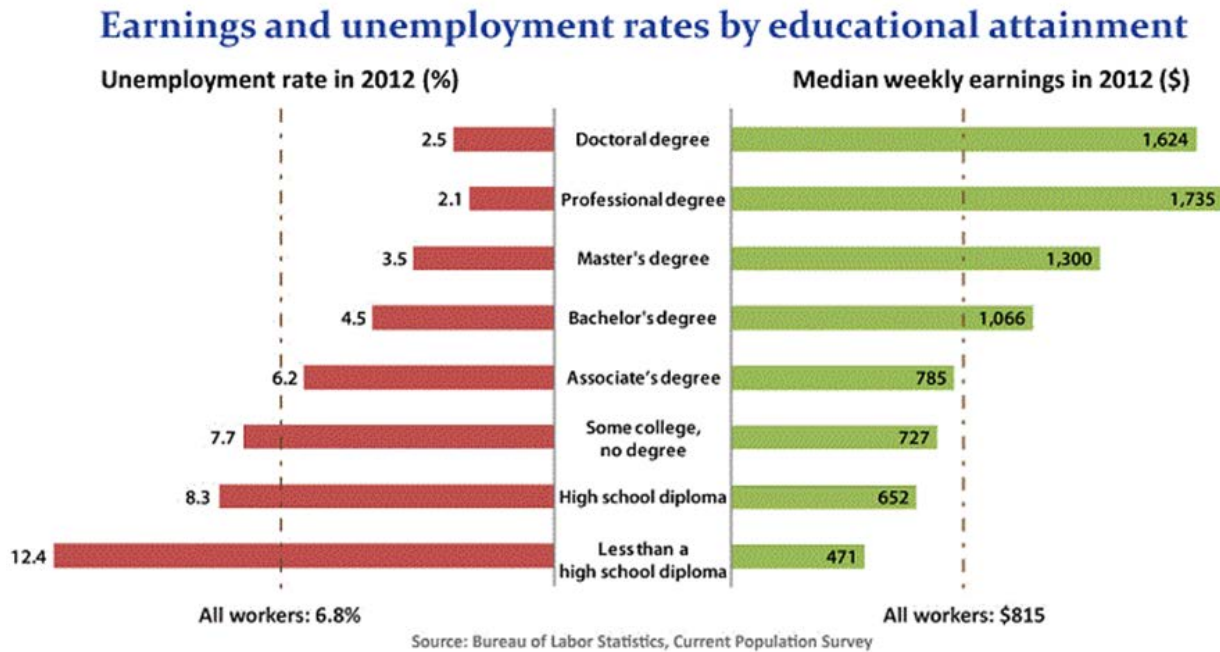
Studies regularly demonstrate that those with post-secondary degrees have a higher earning potential over the course of their lifetime than their counterparts with only a high school

¹³ U.S. Census Bureau (March 2013). *Educational Attainment in the United States: 2012*.

¹⁴ U.S. Census Bureau (February 2012). *Educational Attainment in the United States: 2009*.

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diploma. The following chart highlights the dramatic pay disparity between an individual with a bachelor's degree from a four-year university and one with a high school diploma.¹⁵



According to a 2010 study conducted by the National Center for Educational Statistics, college graduates earned 50 percent more than did young adults who completed only high school, and 22 percent more than did those with associate degrees.¹⁶ The median income for young adults with a bachelor's degree was \$45,000, and with an associate degree, \$37,000.¹⁷ These statistics reveal that the cost of obtaining higher education is generally a good “investment” for the borrower.

A. The Problem of Ever Increasing Tuition

Many people believe that a college degree is essential to be competitive in today's workforce. Unfortunately, not everyone is blessed with the financial resources to cover the costs of higher education. Short of obtaining an athletic or academic scholarship, if student loans were

¹⁵ http://data.bls.gov/cgi-bin/print.pl/emp/ep_chart_001.htm.

¹⁶ Crissey, S. and Bauman, K. (April 2010). *Between a Diploma and a Bachelor's Degree: The Effects of Sub-Baccalaureate Postsecondary Educational Attainment and Field of Training on Earnings*.

¹⁷ *Id.*

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no longer an option, people from modest means, or worse, would not be able to pursue their higher education goals. Therefore, eliminating student loans altogether is not practical. However, stabilizing or decreasing the cost of higher education may be a viable solution.

The cost of education in the United States is skyrocketing. In fact, the cost of higher education in the United States is among the highest in the world.¹⁸ In 2007, The College Board conducted a study showing that in the 1985-1986 academic year, comprehensive costs at public schools totaled about \$4,000.¹⁹ In 2007, those costs were almost \$13,000.²⁰ At private colleges and universities 20 years ago, comprehensive costs totaled about \$9,000.²¹ In 2007, the number is over \$30,000 a year.²²

B. Recent Backlash Against Student Loan Industry

Recently, the student loan industry has been under attack because of the increasing costs of education coupled with fewer job opportunities, especially for many newly minted college graduates. The recent Congressional debate about rising interest rates on student loans to undergraduate borrowers undoubtedly reinforced the popular notion that many student loan borrowers will face crippling debt burdens for a decade or more. This backlash was evident in the “Occupy Wall Street” movement’s protests about student loan debt and the inability of some borrowers to obtain meaningful employment. Even the Courts are taking an increasingly angry tone. *See, infra.* discussion at ¶ IV.C.

¹⁸ Vedder, Richard (July 2004). *Going Broke by Degree: Why College Costs Too Much*. American Enterprise Institute.

¹⁹ <http://abcnews.go.com/WNT/PersonalFinance/story?id=2865814&page=1>

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

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IV. Discharging Student Loan Debt in Bankruptcy

The purpose behind Section 523(a)(8) is, in part, to prevent abuse by graduates attempting to discharge student loans “on the eve of a lucrative career.”²³ Furthermore, Congress has sought to protect the solvency and perpetuity of student loan programs.²⁴ More specifically, Congress passed such legislation to “assure that future generations of students will also have an educational loan available to them in their pursuit of a higher education.”²⁵ Congress’ stated philosophy and intent in enacting Section 523(a)(8) requires those who take advantage of the federal government’s “deliberately generous approach to granting educational loans” to repay such loans.²⁶

Under the existing framework, a debtor can discharge federally backed student loan debt only if the debtor demonstrates that paying back the debt would create an “undue hardship” on the debtor and the debtor’s dependents.²⁷

A. Undue Hardship: One Legal Standard, Two Tests - *Brunner v. Totality of Circumstances*

Because the Bankruptcy Code does not define “undue hardship,” courts have developed two tests to construe what Congress intended debtors to prove before they could discharge of their federally backed student loans:

1. The *Brunner* Test: Nine circuit courts of appeal have adopted the *Brunner* test, under which a debtor must demonstrate:

- (1) an inability to maintain, based on current income and expenses, a “minimal” standard of living if forced to repay the loans;

²³ *Andresen v. Neb. Student Loan Program Inc. (In re Andresen)*, 232 B.R. 127, 130 (B.A.P. 8th Cir. 1999).

²⁴ 125 Cong. Rec. S. 9160 (daily ed. July 11, 1979) (remarks of Senator DeConcini).

²⁵ *Id.*

²⁶ 125 Cong. Reg. H. 2759 (daily ed. May 7, 1979) (remarks of Rep. Hyde).

²⁷ 11 U.S.C. § 523(a)(8).

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- (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) good faith efforts to repay the loans.²⁸

In *Brunner*, the debtor sought to discharge student loan debt a month after her loans came due. After considering the debtor's testimony that she had tried unsuccessfully to find work in her specified field of study and that her finances were shaky, the bankruptcy court discharged the debtor's student loans. The lender appealed, and the district court reversed, holding that although the term "undue hardship" is not defined in the Bankruptcy Code, the term "undue" as used in § 523(a)(8) indicated that Congress viewed "garden variety" hardship as an insufficient excuse for a discharge of student loans.

2. The "Totality of the Circumstances" test:

a. **Eighth Circuit:** The Eighth Circuit rejected the *Brunner* test and instead adopted the so-called "totality of the circumstances" test to determine undue hardship under Section 523(a)(8). The totality test requires a bankruptcy court to consider:

- (1) the debtor's past, present, and reasonably reliable future financial resources;
- (2) the debtor's and her dependent's reasonable necessary living expenses; and
- (3) any other relevant facts and circumstances surrounding each particular bankruptcy case.²⁹

The Eighth Circuit summed up this test as follows: "Simply put, if the debtor's reasonable future financial resources will sufficiently cover payment of the student loan debt—while still allowing for a minimal standard of living—then the debt should not be discharged."³⁰

²⁸ See *Brunner v. N.Y. State Higher Educ. Servs. Corp. (In re Brunner)*, 831 F.2d 395 (2d Cir. 1987), affirming *Brunner v. N.Y. State Higher Educ. Servs. Corp. (In re Brunner)*, 46 B.R. 752, 753 (S.D.N.Y. 1985).

²⁹ *Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 322 F.3d 549, 553, 554 (8th Cir. 2003).

³⁰ *Id.* at 554-55; see generally Julie Swedback & Kelly Prettnner, *Discharge or No Discharge? An Overview of Eighth Circuit Jurisprudence in Student Loan Discharge Cases*, 36 Wm. Mitchell L. Rev. 1679 (2010).

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Proponents of the totality of the circumstances test praise the test for its flexible and meticulous fact specific approach. On the other hand, the test is criticized by courts adhering to *Brunner* as undermining consistency, predictability, and fairness by allowing too much judicial discretion. These courts argue that the totality of the circumstances test is too subjective as the Court reviews whatever factors it deems relevant under the third prong.

b. First Circuit: The First Circuit has not adopted a formal test:

We see no need in this case to pronounce our views of a preferred method of identifying a case of “undue hardship.” The standards urged on us by the parties both require the debtor to demonstrate that her disability will prevent her from working for the foreseeable future. Appellant has a formidable task, for Congress has made the judgment that the general purpose of the Bankruptcy Code to give honest debtors a fresh start does not automatically apply to student loan debtors. Rather, the interest in ensuring the continued viability of the student loan program takes precedence.

Nash v. Conn. Student Loan Found. (In re Nash), 446 F.3d 188, 190-91 (1st Cir. 2006).

B. Brunner vs. Totality: Does Really It Matter?

Courts using the totality test claim that “a ‘case-by-case approach that is fact sensitive . . . affords a determination that contextually considers both the debtor’s situation and the policies underlying § 523(a)(8) [and] ensures an appropriate, equitable balance [between] concern for cases involving extreme abuse and concern for the overall fresh start policy.’”³¹

Courts using the *Brunner* test claim “it provides a workable, easily articulated framework for courts and parties to follow while still allowing for a fact- and case-sensitive determination.” *Id.* Also, *Brunner* courts claim “that adopting the Brunner test will ‘create[] more certainty and predictability by establishing concrete factors.’” *Id.*

³¹ *In re Hicks*, 331 B.R. 18 (Bankr.D.Mass. 2005) (internal citations omitted).

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Although two tests have emerged, both generally consider the same criteria: ability to pay now and in the future, whether the debtor has maximized income and minimized expenses, and attempts to repay the debt a/k/a the “good faith” prong, which requires both looking back and looking forward to decide if the debtor has made a good faith effort to repay the debt. In totality of the circumstances jurisdictions, courts will generally consider criteria related to *Brunner’s* “good faith” prong under the totality’s “any other relevant facts” prong. Ultimately, because there is one legal standard, it may not matter which test is applied.

C. Recent Backlash Against the *Brunner* Test

After nearly three decades of courts at all levels construing the statutory undue hardship legal standard and creating a vast body of case law under the *Brunner* test, a few courts have begun questioning *Brunner’s* viability. Contributing to this growing dissent is the fact that Congress repealed the “time in repayment” provision of Section 523(a)(8),³² leaving undue hardship as the only means of discharging student loan debt in bankruptcy. Further, there is the factoid that the federal government made a \$51 billion profit on student loans in 2013 alone. The Congressional Budget Office (“CBO”) arrived at this figure using calculations mandated by Congress. However, the CBO is critical of these calculations and has argued instead for use of the “fair-value accounting” method. Under that method, the government would actually lose \$3.5 billion in 2013 and approximately \$95 billion between 2013 and 2023.³³

Recently, the student loan dissent has dramatically increased despite the availability of administrative options, including flexible, income driven repayment plans. Some courts view administrative options as improperly usurping their judicial authority. *See* Terrence

³² The Higher Education Amendments of 1998 repealed the so-called “Seven-Year Rule” of 11 U.S.C. § 523(a)(8)(B).

³³ Washington Post, July 11, 2013, [www.washingtonpost.com/blogs/fact-checker/post/elizabeth-warrens-claims-that-the-US-earns-\\$51-billion-in-profits-on-student-loans](http://www.washingtonpost.com/blogs/fact-checker/post/elizabeth-warrens-claims-that-the-US-earns-$51-billion-in-profits-on-student-loans).

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L. Michael & Janie M. Phelps, “Judges?!- - We Don’t Need No Stinking Judges!!!”: *The Discharge of Student Loans in Bankruptcy Cases and the Income Contingent Repayment Plan*, 38 Tex. Tech L. Rev. 73 (Fall 2005); *see also In re Todd*, 473 B.R. 676 (Bankr. Md. 2012) “There is no indication that Congress intended to supplant [the undue hardship inquiry] with the Ford Program and its existence should not be treated as an implicit repeal of Section 523(a)(8)”; *In re Bene*, 474 B.R. 56 (Bankr. W.D.N.Y. 2012) (arguing for reversal of *Brunner*); *In re Roth*, 490 B.R. 908 (9th Cir. BAP 2013) (concurrence discusses lesson learned from “America’s experience in the recent ‘mortgage crisis’” and urging the Ninth Circuit to re-visit its adherence to the *Brunner* test, specifically the “good faith” prong.); *In re Cummings*, 2007 WL 3445912 (Bankr. N.D. Cal. 2007) (“This court has long been spitting into the wind by noting that the [*Brunner*] test is a terrible example of judge-made law which gives no real guidance to a court in determining what undue hardship is.”).

V. Administrative Remedies vs. Section 523(A)(8): Is There Common Ground?

A. Exhaustion of Administrative Remedies

In general, individuals must exhaust all administrative remedies available under a statute before resorting to judicial review. *See, e.g., Myers v. Bethlehem Shipbuilding Corp.*, 303 U.S. 41, 50-51 (1938). This rule both protects administrative authority and promotes judicial efficiency. *McCarthy v. Madigan*, 503 U.S. 140, 145 (1992) (“Agencies, not the courts, ought to have primary responsibility for the programs that Congress has charged them to administer.”).

B. Interplay of Administrative Remedies and the Bankruptcy Code

There is growing tension about the significance that administrative remedies should play in a bankruptcy court’s judicial determination of student loan discharge. Fundamental

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principles of statutory construction require courts to construe statutes harmoniously to avoid absurd results:

If a literal construction of the words of a statute be absurd, the act must be so construed as to avoid the absurdity. The court must restrain the words. The object designed to be reached by the act must limit and control the literal import of the terms and phrases employed.

Rector, etc. of Holy Trinity Church v. United States, 143 U.S. 457, 460 (1892). It is unlikely that Congress intended administrative remedies to supplant legal remedies in 11 U.S.C. § 523(a)(8) or vice versa. The majority view is that administrative programs, especially the Department of Education's flexible repayment options, while not dispositive on the "good faith" prong of *Brunner*, must be considered an important component of the undue hardship analysis.

C. Courts Disagree on the Significance of the Available Repayment Options

The U.S. Department of Education has formulated several feasible and affordable repayment options to help student loan borrowers manage and repay their debts. Two of the best known as the "Income Based Repayment Plan" ("IBR") and the "Income Contingent Repayment Plan" ("ICR"). Several circuit-level cases have held that the IBR and ICR are an important consideration in the undue hardship analysis: *Educ. Credit Mgmt. Corp. v. Jespersen (In re Jespersen)*, 571 F.3d 775, 783 (8th Cir. 2009) ("When a debtor is eligible for the ICR, the court in determining undue hardship should be less concerned that future income may decline. The ICRP formula adjusts for such declines, without regard to the unpaid student loan balance, which in most cases will avoid undue hardship"); *Educ. Credit Mgmt. Corp. v. Mason (In re Mason)*, 464 F.3d 878, 885 (9th Cir. 2006) (debtor failed good faith prong in part because of failing to pursue the alternative payment arrangements with any diligence); *Educ. Credit Mgmt. Corp. v. Frushour (In re Frushour)*, 433 F.3d 393, 396-397 (4th Cir. 2005) (failure to seek out loan

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consolidation options to make the debt less onerous is an important inquiry in good faith); *Tirch v. Pa. Higher Educ. Assistance Agency (In re Tirch)*, 409 F.3d 677, 682 (6th Cir. 2005) (although not necessarily a per se indication of bad faith, failure to take advantage of the ICRP is certainly probative of his intent to repay and is a “difficult, although not necessarily insurmountable burden” to overcome); *Alderete v. Educ. Credit Mgmt. Corp. (In re Alderete)*, 412 F.3d 1200, 1206 (10th Cir. 2005) (failing to consider alternative repayment options indicative of bad faith).

However, the ICR and IBR have recently been criticized by the Seventh Circuit in *In re Krieger*, 713 F.3d 888 (7th Cir. 3013). The Seventh Circuit Court of Appeals found that the debtor “is destitute [and] [h]er entitlement to a discharge in bankruptcy is unquestioned.”³⁴ The strong conviction expressed in the first sentences of the opinion written by Chief Judge Easterbrook set the tone for the entire opinion. At the time of trial, Krieger was an unemployed 52-year-old living with her mother in a rural community where few jobs are available.³⁵ According to the evidence presented at trial, the debtor and her mother only had a few hundred dollars from governmental programs between the two every month.³⁶ While the Seventh Circuit did not formally adopt the totality of the circumstances test, the Court held that despite the debtor's failure to inquire about and take advantage of available repayment programs, the debtor nevertheless meets the third prong of the *Brunner* test if the debtor's current circumstances are unlikely to change.³⁷ This is a significant change in favor of debtors in the Seventh Circuit where it has long been held that if the debtor fails to inquire and make a genuine effort to participate in the Ford Program, the debtor would be unable to satisfy the good faith prong of the test and would not be entitled to receive a discharge.

³⁴ *Krieger v. Educ. Credit Mgmt. Corp. (In re Krieger)*, 713 F.3d 882, 883 (7th Cir. 2013).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.* at 885.

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VI. Why Eliminating 11 U.S.C. Section 523(a)(8) Is Not the Answer

While it is true that millions of student loan borrowers are currently facing large loans and a sluggish job market, amending the Bankruptcy Code to eliminate the student loan exception to discharge is not the answer.

A. The Current Framework is Already Doing its Job

Despite the rigor of the “undue hardship” test, numerous cases under both *Brunner* illustrate that bankruptcy courts use its framework to fairly apply the facts of each specific case. Congress’ choice to use a broad phrase such as “undue hardship” gives bankruptcy judges the authority and responsibility to decide on a case-by-case basis whether the debtor is entitled to a finding of undue hardship based upon their particular circumstances.³⁸ The undue hardship framework, however, provides meaningful guidance so that there is some level of consistency and predictability to the cases.

Moreover, the courts have already fashioned the equitable remedy of partial discharge as an alternative to a total discharge of student loan debt. It is employed when a court concludes that, although repayment of the debtor’s student loan debt would constitute an undue hardship, the debtor nevertheless has the ability to repay some smaller amount of the overall debt. *See e.g., In re Saxman*, 325 F.3d 1168 (9th Cir. 2003) (partial discharge is available only after debtor proves all three undue hardship prongs.).

Contrary to the argument that the undue hardship test is unduly burdensome, at least two recent studies have found that a large number of borrowers prevail at litigation. One study analyzed each undue hardship case filed in the Western District of Washington over the five-year period from 2002 through 2006. This study found that judges granted a discharge in

³⁸ *See Nash v. Conn. Student Loan Found. (In re Nash)*, 330 B.R. 323,130826 (Bankr. D. Mass. 2005).

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approximately 57% of those cases.³⁹ Another study analyzed a nationwide sample and found that bankruptcy judges grant an undue hardship discharge to nearly forty percent of the debtors that seek one.⁴⁰ Therefore, the undue hardship tests do not pose the insurmountable hurdles popularly portrayed by the media.

B. Lenders Will No Longer be Willing to Assume the Risk

Student loans are generally made to young adults, ages 18-22, nearly none of whom has substantial work experience, credit, or assets. In loaning this money, the government cannot look into the credit history of these borrowers as these Federally backed loans are made without reference to ability to pay. In the case of private lenders, these youthful borrowers simply do not have credit histories sufficient to justify the large loans necessary to pay for higher education. A loan of tens of thousands of dollars to 18-22 year-olds without any collateral whatsoever, and without a guarantee that their educational choices will pay off, is an extremely risky loan. Removing the discharge exception for these lenders would create an even riskier loan.

C. Burden on Taxpayers

It goes without saying that nobody likes to pay for someone else's debt. Why should American taxpayers absorb the costs associated with a student's decision to pursue higher education when that decision did not end up paying off in the long run? Repaying student loans should ultimately be the responsibility of the borrower who made the decision to obtain that

³⁹ *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 Am Bankr.L.J. 179 (2009).

⁴⁰ *An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard*, 86 Am Bankr.L.J. 495 (2012).

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higher education. This is especially true given the additional burden that student loans are presenting to the federal deficit.⁴¹

D. Flexible and Affordable Repayment Options Already Exist

There are numerous options available inside or outside of bankruptcy to provide relief to student loan borrowers suffering financial hardship.

1. Consolidation

Consolidation benefits a borrower by spreading the payments over a term of up to 30 years, depending on the total loan balance. Since July 2009, consolidations are available only in the William D. Ford Direct Loan Program. Borrowers who have previously consolidated their loans in the Federal Family Education Loan (“FFEL”) Program may reconsolidate their loans (even if defaulted) into the Direct Loan Program but not vice-versa. Some of the repayment options include: (1) Extended Graduated Repayment, (2) Extended Fixed Repayment, (3) an Income Based Repayment Plan (“IBR”), (4) an Income Contingent Repayment Plan (“ICRP”), (5) a Graduated Repayment Plan, and (6) a Standard Repayment Plan.

a. Extended Graduated Repayment

Under this repayment option, the payments start out low and increase every two years for a total of 25 years.

b. Extended Fixed Repayment

This repayment option is similar to the extended graduated monthly repayment option except under this option, the payment would remain fixed for 25 years.

⁴¹ Washington Post, July 11, 2013, [www.washingtonpost.com/blogs/fact-checker/post/elizabeth-warrens-claims-that-the-US-earns-\\$51-billion-in-profits-on-student-loans](http://www.washingtonpost.com/blogs/fact-checker/post/elizabeth-warrens-claims-that-the-US-earns-$51-billion-in-profits-on-student-loans).

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c. **Income Based Repayment Plan (“IBR”)**

i. **Eligibility for IBR:** Defaulted student loans, PLUS loans, or federal consolidation loans that contain underlying PLUS loans or a mix of Stafford loans and PLUS loans are not eligible for the IBR in either the FFEL Program or the Direct Loan Program). Stand-alone Perkins loans are not eligible for the IBR either. Nevertheless, borrower may include a Perkins loan in a consolidation loan that will be IBR-eligible.

Borrowers who have defaulted FFEL Program loans may re-consolidate their defaulted loans into the Direct Loan Program and elect the IBR in the Direct Loan Program. (Re-consolidating removes the default because the borrower has a new loan). Borrowers also have a one-time opportunity to rehabilitate their loan to remove the default status and be eligible for the IBR in either federal student loan program. *See supra*.

ii. **Calculating the IBR:** Borrowers who have IBR-eligible loans must first demonstrate partial financial hardship (PFH). Borrowers can demonstrate PFH if the annual amount due on all eligible student loans under a 10-year repayment schedule is more than 15% of their adjusted gross income (AGI). Most borrowers whose total loan balance exceeds their annual earnings will satisfy the PFH requirement.

The IBR payment is calculated using the borrower’s AGI and family size. If the borrower earns less than 150% of the poverty level for their family size, the IBR payment will be \$0. The required annual loan payment under the IBR is capped at 15% of earnings above 150% of the applicable poverty level. Because the monthly IBR payment is calculated as a percentage of the borrower’s income, if the borrower’s income drops, the monthly payment is reduced accordingly.

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The IBR payment is recalculated annually based on household income. Married borrowers who file separate tax returns have their IBR payments based on their own respective incomes but may still count each other and any dependents in the family size. Borrowers may contact their lender/servicer at any time if they experience a change in financial circumstances that could impact their required IBR payment. The IBR repayment period is 25 years. At the conclusion of the 25-year repayment period, any remaining balance is forgiven by the Department of Education.⁴² *But see infra* discussion of 10-year repayment term for the Public Service Loan Forgiveness Program.

d. Income Contingent Repayment Plan (“ICRP”)

Like the IBR, the ICRP is recalculated annually and the payment amount is based on 20% of the difference between a borrower’s AGI and 100% of the federal poverty level for the family size. If the AGI is below 100% of the poverty level for the borrower’s family size, then the ICRP payment is \$0. The ICRP is the only income-driven payment option available to PLUS loan borrowers or to borrowers who have defaulted loans in the Direct Loan Program. The ICRP is always based on household income regardless of tax filing status. At the end of the 25-year repayment period, any remaining balance would be cancelled by the Secretary of Education. *See supra* Note 42.

e. Graduated Repayment Plan

Under the Graduated Repayment Plan, payments start out low and increase every two years. The starting payment is calculated as one-half the monthly payment under the Standard Repayment Plan or the amount of interest that accrues monthly, whichever is

⁴² Under the Internal Revenue Code, student loan debt forgiven at the end of the IBR (and ICRP, discussed *infra*) term may constitute a taxable event. This is a nonissue in most cases because any forgiven debt is taxable only to the extent the borrower is solvent. Thus, it is unlikely that borrowers with large student loan debts will have assets that exceed the debt forgiven 25 years into the future.

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larger. The monthly payment will never increase to more than 1.5 times the amount that would be paid under the Standard Repayment Plan. These payments would remain the same regardless of a change in income.

f. Standard Repayment Plan

Under the Standard Repayment Plan, borrowers pay a fixed monthly amount, which must be at least \$50, over a period of no more than 10 – 30 years depending upon the loan balance and until the loan is repaid. Under this option, the payments would remain the same regardless of a change in income.

E. Will Needlessly Force Student Loan Borrowers into Bankruptcy

Modifying the Bankruptcy Code to make it easier for student loan borrowers to obtain a discharge of their student loan debt will burden the already taxed bankruptcy courts. Borrowers will enter bankruptcy even if they have no other basis to reorganize or liquidate. This will negatively impact their credit rating and may prevent or delay these borrowers from obtaining bankruptcy relief if the need truly arises later.

F. Discharge of Student Loans Exists Outside of Bankruptcy

Short of proving undue hardship, a student may discharge their federally guaranteed or existing loan by several mechanisms:

1. Closed School – Student unable to Complete due to Closure

Borrowers may be eligible for discharge of federal loans if their school closed before they could complete the program of student. The borrower must show they were enrolled at the time of closure or that they withdrew from the school not more than 90 days prior to the date the school closed and that they were unable to complete the program of study through

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a teach-out at another school or by transferring academic credits or hours earned at the closed school to another school.

2. False Certification of Student Eligibility or Unauthorized Payment Discharge

A borrower may be eligible for a discharge if (1) a school falsely certified the student's eligibility for a federal student loan on the basis of ability to benefit from the education, (2) signed the borrower's name without authorization by the borrower on the loan application or promissory note, or (3) someone else obtained a federal student loan because of identity theft.

3. Total and permanent disability

Borrowers may be eligible to have their federal student loan debt discharged because of a total and permanent disability. A medical doctor or doctor of osteopathy must certify that the borrower (1) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that (i) can be expected to result in death; (ii) has lasted for a continuous period of not less than 60 months; or (iii) can be expected to last for a continuous period of not less than 60 months; or (2) as been determined by the Secretary of Veterans Affairs to be unemployable due to a service-connected disability. Such borrowers can seek a TPD discharge of all federally backed loans by submitting a one-page application directly to the Department of Education, rather than separate applications to each individual loan holder. That application contains a certification from a physician on the TPD discharge application corroborating the existence of the borrower's disabling condition.

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If the TPD request is approved, the account is immediately discharged by the Dept. of Education.⁴³ The Dept. of Education will monitor the account for a three years post-discharge, running from the date the borrower's account is assigned to the Dept. of Education's disability servicer, Nelnet. During this three-year period, borrowers cannot earn more than 100% of the federal poverty guidelines for a family of two (in 2013 = \$15,510) and cannot have obtained any new federal student loans. Typically, the Dept. of Education's Disability Servicer (Nelnet) will contact the borrower when the three-year mark is approaching to update the disability status and financial status to ensure that the borrower's discharge criteria have not changed.

4. Social Security Disability

Significant changes to the TPD process, favoring the borrower, recently took effect on July 1, 2013. Under these new regulations, an individual demonstrates that he or she is totally and permanently disabled if he or she is receiving Social Security Disability Insurance (SSDI) or Supplemental Security Income (SSI) benefits, and submits a Social Security Administration (SSA) notice of award for SSDI or SSI benefits stating that the individual's next scheduled disability review will be within 5 to 7 years from the date of the individual's most recent SSA disability determination. An individual who provides this documentation is not required to obtain a separate certification from a physician on the TPD discharge application, as was previously required.

⁴³ Under the Internal Revenue Code, student loan debt forgiven or discharged by TPD may constitute a taxable event. This is a nonissue in most cases because any forgiven debt is taxable only to the extent the borrower is solvent. Thus, it is unlikely that borrowers with large student loan debts will have assets that exceed the debt discharged by TPD.

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5. Death

If an individual borrower dies, or the student for whom a parent received a PLUS loan dies, then the obligation of the borrower and any endorser to make any further payments on the loan is discharged.

6. Teacher Forgiveness Loan Program

Particular borrowers may be able to have as much as \$17,500 of their subsidized or unsubsidized federal student loans forgiven if they have been teaching full-time in a low-income elementary or secondary school or educational service agency for five consecutive years. 34 C.F.R. § 685.217 - Direct Loan Program loans only.

7. Survivor of September 11, 2001 attacks

Survivors of or eligible victims of the September 11 attacks may request discharge of their student loan debt. (Direct Loan Program loans only).

8. Public Service Loan Forgiveness Program

Borrowers who are employed in the public service industry, including most local, state, federal, tribal nation, or § 501(c)(3) corporations and who make 120 qualifying payments under the IBR, ICR, or 10-year fixed payment schedule while employed in the public sector are eligible to have any balance remaining on their student loan debt forgiven. In addition, there is specific language in this regulation that exempts any forgiven debt from constituting a taxable event. (Direct Loan Program loans only)

9. Alternative Payment Arrangements

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If a Borrower believes that none of the payment options is appropriate, he/she may request an alternative repayment plan from the Secretary of Education. *See* 34 C.F.R. § 685.208(g).

10. Veterans with service-connected disabilities

Veterans who have a 100% service-connected disability are immediately eligible for discharge of their federal student loan debt without further certification under the TPD regulation. They need only provide their Veteran's Administration disability rating paperwork to the loan holder who will process the discharge.

11. Loan Rehabilitation

Federal regulations allow borrowers who default on repayment of their loan a one-time opportunity to bring their loans out of a default status and repair the negative credit information reported to credit bureaus. Payment amounts are set at a reasonable rate and borrowers must make nine consecutive on-time payments over a 10-month period. Completing rehabilitation restores a borrower's loans to good standing and helps to repair credit. Entering a loan rehabilitation agreement has immediate effect on a borrower's defaulted loans: it stops all collections activity and legal proceedings, prevents wage garnishment, and it may protect a borrower's state and federal tax refunds from IRS offsets.

Successfully completing a loan rehabilitation program restores loans to their pre-default status, it reestablishes eligibility for deferment, forbearance, alternative repayment options, title IV financial aid, resets loans to their original terms, interest rate, and repayment period, minus the 9-month rehabilitation period, and shows positive payment progress on a borrower's credit report, which may repair some of the damage done by default.).

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VII. Conclusion

Government backed student loans should remain presumptively non-dischargeable in bankruptcy. Such loans are funded by taxpayers and given to borrowers with uncertain financial futures, little to no assets, and without regard to credit history and underwriting standards. Further, studies show that bankruptcy courts already discharge approximately 40% of loans in undue hardship litigation. Allowing borrowers to simply walk away from their student loan obligations would chill the marketplace for student loans. Interest rates would necessarily increase because of the additional risk presented by bankruptcy. The amount of federal funds available for student loans might be reduced, thereby increasing reliance on private student loans, which have significantly different repayment options and terms compared to federally backed student loans.

As a matter of public policy, our society has decided that access to higher education is one of our country's top priorities. To help effectuate this policy, Congress enacted Section 523(a)(8) to provide certain protections that allow the government to provide low-interest loans to even the least credit-worthy borrowers. Materially altering Section 523(a)(8) to allow for the discharge of federally backed student loans is simply not the answer to this complex problem.

Resources

- National Student Loan Data System (www.nsls.ed.gov)
- ED PIN website: (www.pin.ed.gov)
- Federal Student Aid (government website): (<http://studentaid.ed.gov>)
- Finaid (consumer financial aid website): (www.finaid.org)
- Department of Education (www.ed.gov)
- William D. Ford Direct Loan Program (www.loanconsolidation.ed.gov)
- National Counsel of Higher Education Resources (www.ncher.us)
- Educational Credit Management Corporation (www.ecmc.org)
- Direct Loan (Ford program) Forms: (<https://www.dl.ed.gov/borrower>)