

# **You Got an Education, Now Pay the Bill: The Dischargeability of Student Loans**

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Dealing with the problem of possible future tax liability when the balance of the student loan debt is forgiven at the end of an ICRP or IBR.

- Tax liability is not a certainty. *ECMC v. Bronsdon*, 421 B.R. 27, 35-36 (D. Mass. 2009).
- Can the bankruptcy court discharge future tax liability in a 523(a)(8) adversary where the IRS is not a party? Cf. *In re Brunell*, 356 B.R. 567, 581 (Bankr. D. Mass. 2006)(discharging potential tax liability), with *In re Stevenson*, 463 B.R. 586, 599 (Bankr. D. Mass. 2011)(discharging any student loan debt remaining at completion of ICRP, which could have the effect of avoiding tax liability for forgiveness of debt).

What is the effect of the student loan creditor's right to intercept tax refunds? Does that create a secured claim? Implications if it does:

- Debtor may be able to pass means test in Chapter 7
- In Chapter 13, can debtor pay student loan debt as long term secured debt?
- In Chapter 13, is the creditor secured only for the first refund, or for all refunds? Debtor can change withholding to reduce or eliminate future refunds of taxes paid, that doesn't work for the earned income credit and other refundable tax credits.

Separate classification in Chapter 13.

- Co-signed debt - only if debtor received the education?
- Section 1322(b)(10) says plan can't pay interest on unsecured debt that is nondischargeable under section 1328(a) unless it is a 100% plan. Does this mean that plan can't provide for separate classification of long term debt? *In re Kubeczko*, 2012 WL 2685115 (Bankr. D. Colo. 2012); *In re Stull*, 2013 WL 1279069 (Bankr. D. Kan. 2013). But note that the prohibition against paying interest is not limited to long term debts that are not discharged pursuant to 1328(a)(1).
  - Does this limit the ability of the debtor to enter into an ICRP or IBR while the Chapter 13 case is pending?

**ANATOMY OF AN ADVERSARY PROCEEDING INITIATED BY A DEBTOR UNDER SECTION 523(a)(8) OF THE BANKRUPTCY CODE**

**Mark E. Shure**

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

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

(8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor’s dependents, for (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or (B) any other educational loan that is qualified education loan as defined in section 221(d) (1) of the Internal Revenue Code of 1986, incurred by debtor who is an individual.

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

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

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

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

**B. Who is the Creditor?**

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

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

proceeding. In the event the Chapter 13 debtor subsequently files an adversary proceeding seeking a discharge of his or her student loans, that proceeding would be defended by ECMC, even if the debtor sued a former holder of the loan. As noted above, even if the debtor brings the suit against an entity that is no longer holding the loan, the entity who is named will typically advise the current holder about the case and that holder will then appear, intervene, and defend the action.

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

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

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

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

the Second and Seventh Circuits, the *Brunner* test has also been adopted in the Third, Fourth, Fifth, Sixth, Tenth and Eleventh Circuits.

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

1. **The Brunner Test**

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

- (1) He cannot maintain, based on current income and expenses, a “minimal” standard of living for himself and his dependents if forced to repay the loans;
- (2) Additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
- (3) He has made good faith efforts to repay the loans.

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

Each of foregoing factors is analyzed separately by the courts.

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

This first prong of the *Brunner* test requires an examination of debtor’s current financial condition. The debtor must show that having to repay the loans would cause the standard of

living of the debtor and his or her dependents to fall below a “minimal” lifestyle. *In re Roberson*, 999 F. 2d at 1135. This is a tough standard for the debtor, because “minimal” does not mean comfortable, or even average. In fact, in addressing what is a “minimal” standard of living, many courts start by looking at the federal poverty guidelines. *See, e.g., O’Hearn v. Educ. Credit Mgmt. Corp.*, 339 F.3d 559, 564 (7<sup>th</sup> Cir. 2003) (in addressing this prong, Seventh Circuit compared debtor’s income to poverty guidelines).

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

**b. Additional Circumstances Exist Indicating Current Circumstances Will Persist**

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

Current unemployment is typically not enough, since that is not a permanent condition. Rather, there must be additional factors which suggest that the current situation, such as

unemployment, is likely to persist. Courts have looked to such factors as the mental or physical disabilities of debtor and his or her dependants, lack of meaningful education or job skills, the debtors' obligation to care for dependents, the debtor's age, and any other facts that might prevent retraining or relocation. *Educational Credit Management Corp. v. Nys*, 446 F.3d 938, 946 (9<sup>th</sup> Cir. 2006). The burden remains on the debtor "to prove that he cannot earn more money in the years to come..." *In re Mallinckrodt*, 274 B.R. 560, 567 (S.D. FL 2002).

**c. Good Faith Effort to Repay**

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

Several courts have suggested that good faith requires a debtor to enter into long term repayment plans to avoid a discharge, such as the Income Based Repayment Plan. These long term plans set repayment obligations based upon a debtor's current income, which could result in payments as low as zero. However, these plans extend for periods up to twenty-five years. A recent case decided by the Seventh Circuit addressed the good-faith standard in the context of these types of payment plans. In *Krieger v Educational Credit Management Corporation*, 2013 WL 1442305 (April 10, 2013), the Seventh Circuit reversed a District Court's ruling that a student loan should not be discharged because the debtor had failed to show good faith by failing to enroll in an income based repayment plan that would have given her twenty-five years to

repay the loan. The Seventh Circuit held that the district court erred by not giving sufficient deference to the bankruptcy court's finding that the debtor had acted in good faith. The Seventh Circuit noted that the district court seemed to think that a debtor is always obligated to agree to a long term payment plan and forego a discharge; according to the Seventh Circuit, that was simply an incorrect proposition of law. In deciding this case, the Seventh Circuit stated: "It is important not to allow judicial glosses, such as the language in *Roberson* and *Bruner*, to supersede the statute itself." In all likelihood, that language will be regularly cited by Debtors in these cases for years to come.

2. **Totality of Circumstances Test**

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

D. **Litigating a Student Loan "Undue Hardship" Case**

In any case initiated to determine "undue hardship", the debtor and debtor's counsel should not initiate the action unless they are fully prepared to go through trial, and possibly also an appeal. Because rulings can impact future cases, many student loan creditors tend to litigate these cases vigorously. Creditors will often not even discuss settlement until after

full discovery is completed, and even then they will not agree to a discharge of the loans in the absence of compelling facts. With the state of the law in this area, student loan creditors are typically very willing to require a debtor to try their case, and if the result is adverse to the creditor, the creditor may very well appeal.

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

### CONCLUSION

Whether viewed under the *Brunner* test or the “totality of circumstances test, “obtaining a discharge of Student loan indebtedness under Section 523(a)(8) of the Bankruptcy Code is difficult, but not impossible. However, under either standard the debtor must take the initiative

by initiating the adversary proceedings and the debtor will have to establish the relevant factors by preponderance of evidence. Consequently, unless a debtor has a significant chance of establishing the necessary factors, initiating an undue hardship adversary proceeding might not be worth the time, cost and effort to the debtor.

# Lawyers? Who Needs Lawyers?

## Administrative Alternatives to Bankruptcy Discharge of Student Loan Debt

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### I. GENERAL OVERVIEW OF STUDENT LOANS

**A. Higher Education Act of 1965:** Almost five decades ago, in response to a perceived need for financial assistance to students in higher education, Congress passed the Higher Education Act of 1965 (HEA). The purpose of the HEA is to “keep the college door open to all students of ability,” regardless of socioeconomic background.

**B. (There Were) Two Federal Student Loan Programs:** The HEA governs two federally-backed student loan programs: the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (the Ford Program). Under the Health Care and Education Reconciliation Act of 2010, Congress eliminated the FFELP, effective July 1, 2010. Currently, the total debt at stake in the two federal student loan programs approaches one trillion dollars.

**1. FFELP:** Under the FFELP, eligible lenders make guaranteed loans on favorable terms to students or parents to help finance student education. The loans are guaranteed by guaranty agencies (state agencies or private non-profit corporations), which are ultimately reinsured by the United States Department of Education (ED). The majority of state guarantors assign their student loans in litigation to Educational Credit Management Corporation (ECMC).<sup>1</sup>

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<sup>1</sup> ECMC is a private nonprofit guaranty agency, head-quartered right outside of St. Paul, Minnesota. ECMC is a guarantor in the FFELP. Guarantors guarantee loans in the event of a default or temporarily if the borrower files a chapter 13 bankruptcy. ECMC is the designated guarantor in the Commonwealth of Virginia, and Oregon, Connecticut, and California, among other states. ECMC is also a specialized guarantor in that it receives transfer of student loans that are in a chapter 13 bankruptcy status from the U.S. Department of Education and other guaranty agencies in the FFELP. Approximately half of the guaranty agencies transfer their Chapter 13 bankruptcies to ECMC to manage while the bankruptcy is active and to defend any subsequent litigation that may arise during or after the bankruptcy.

**2. The Ford Program:** Under the Ford Program, ED makes loans directly to student and parent borrowers from the federal treasury.

**C. Types of Federal Loans:**

**1. HEA:** Loans under the HEA include Perkins Loans, Stafford (subsidized and unsubsidized) Loans, PLUS Loans and Consolidation Loans. Grants include Pell Grants and Supplemental Education Opportunity Grants. The terms of Stafford, PLUS and Consolidation loans in both the FFELP and the Ford Program are similar except that the Ford Program offers two income-related payment options (IBR and ICR) as well as a Public Service Loan Forgiveness program (discussed *infra* at II.F, III.B.3).

**2. Health and Human Services Loans:** The United States Department of Health and Human Services (DHHS) also administered a student loan program, Health Education Access Loan program, (HEAL), for borrowers engaged in health related studies. This program is no longer active. Like FFELP loans, HEAL loans are also presumptively nondischargeable. Courts have construed the dischargeability standard of “unconscionability” for HEAL loans as being a “higher standard” than that of FFELP/Ford loans, which require a showing of “undue hardship.” Even though HEAL loans are administered by DHHS, HEAL loans are eligible for consolidation along with FFELP loans into ED’s Ford program.

**D. Non-HEA Loans: Private Loans:** Private label loan programs also emerged on the scene to provide educational funds to students who have exhausted their federal loan limits or are otherwise ineligible to borrow under the federal loan programs. Private label loans are not eligible for administrative relief discussed below and may not be consolidated under federally-backed consolidation programs. The bankruptcy reform legislation of 2006, however, expressly included private loans in the presumption of nondischargeability under 11 U.S.C. § 523(a)(8).

**II. NON-BANKRUPTCY RELIEF**

There are numerous administrative remedies for student loan borrowers to consider in lieu of seeking discharge under § 523(a)(8). Unlike relief under 11 U.S.C § 523(a)(8), borrowers may be entitled to administrative relief irrespective of whether they’ve filed bankruptcy. But these administrative options require administrative determinations and, thus, should not be the basis for claim objections or adversary proceedings in a bankruptcy context.<sup>2</sup>

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<sup>2</sup> The discharge provisions described here are illustrative only of the administrative relief available under the HEA. For full detail of requirements necessary for relief, see 34 C.F.R. §§ 682.100 *et seq.*, 685.100 *et seq.* These administrative options are available for both FFELP and Ford Program loans unless otherwise noted.

**A. Total and permanent disability (TPD) discharge:** 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) has been determined by the Secretary of Veterans Affairs to be unemployable due to a service-connected disability.

If the TPD request is approved, there is a three-year post-monitoring period, running from the date the loan is assigned to ED. During this three-year period, borrowers cannot earn more than 100% of the federal poverty guidelines for a family of two (in 2011 = \$14,710) and cannot have obtained any new federal student loans.

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 and a signed copy of Page 1 of the TPD application to the loan holder who will process the discharge. The VA paperwork is used in lieu of the doctor certification on the TPD application.

**B. Closed school discharge:** Borrowers whose school closed before they could complete the program of study may be eligible for discharge. 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 a teach-out at another school or by transferring academic credits or hours earned at the closed school to another school.

**C. False certification discharge:** A borrower's student loans can be discharged if a school falsely certified the student's eligibility for a federal student loan on the basis of ability to benefit from the education, knew the borrower had a "status" that disqualified them from employment in their area of study (e.g. a truck driving school enrolling a student who is not eligible for a Class C license because of a prior driving related offense), signed the borrower's name without authorization by the borrower on the loan application or promissory note, or someone else obtained a federal student loan because of identity theft.

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

**E. Teacher Loan Forgiveness Program:** Teachers who meet the requirements in 34 C.F.R. § 685.217 are eligible for forgiveness of up to \$17,500. Typically, this provision is for teachers in low-income areas and those who teach math or

science at schools designated eligible by the U.S. Department of Education. (Ford Program loans only); *But see also infra* II.H).

**F. Public Service Loan Forgiveness:** Borrowers who make 120 qualifying payments under the Income-based or Income-contingent payment options, 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 agencies, tribal nations, or § 501(c)(3) corporations. (Ford Program loans only).

**G. September 11 Survivors Discharge:** Survivors of or eligible victims of the September 11 attacks may request discharge of their student loan debt. (Ford Program loans only).

**H. Administrative discharges specific to Perkins Loans:** In addition to the above-mentioned non-bankruptcy discharge options, borrowers may also request discharge or forgiveness of their Perkins Loans for the following reasons:

- full-time teacher in elementary school serving student from low-income families (up to 100%);
- full-time special education teacher (up to 100%);
- full-time qualified professional provider of early intervention services for the disabled (up to 100%);
- full-time math, science, foreign language, bilingual education, etc. in designated teacher shortage area (up to 100%);
- full-time employee of public or nonprofit child or family-services agency for high-risk children and families from low-income areas (up to 100%);
- full-time nurse or medical technician (up to 100%);
- full-time law enforcement or corrections officer (up to 100%);
- full-time staff member in education component of Head Start Program (up to 100%);
- VISTA or Peace Corps volunteer (up to 70%);
- Service in the U.S. Armed Forces (up to 50% in areas of hostilities or imminent danger);
- full-time teacher in designated educational service agency serving students from low-income families (up to 100%);
- full-time staff in prekindergarten or child care program licensed or regulated by State (up to 100%);
- full-time firefighter (up to 100%);
- full-time faculty member at Tribal College or University (up to 100%);
- full-time speech pathologist with master's degree working in Title I-eligibility elementary or secondary school (up to 100%);
- Master's degreed-librarian working in Title I-eligibility elementary or secondary school or public library serving title-eligible schools (up to 100%);

- full-time attorney working in public or community defender organization (up to 100%)

### **III. FLEXIBLE, AFFORDABLE PAYMENT OPTIONS: INSIDE OR OUTSIDE OF BANKRUPTCY**

Both the FFELP and the Ford Program have flexible, affordable payment options for borrowers who have financial hardship. These payment options are available whether or not the borrower has filed bankruptcy. ECMC will always rely on the most affordable payment amount available to the borrower when arguing undue hardship discharge cases.

**A. Consolidation:** Consolidation benefits a borrower by spreading the payments over a term of up to 30 years, depending on the total loan balance. New consolidations are available only in the Ford Program. Borrowers who have previously consolidated their loans in the FFELP may reconsolidate their loans (even if defaulted) in the Ford Program but not vice-versa.

**B. Income-related payments:** In addition to fixed, amortized extended, graduated payment terms, there are two payments options that are based on a borrower's income and family size: the Income Based Repayment plan (IBR) and the Income Contingent Repayment plan (ICR) (available only in the Ford Program).

**1. Income Based Repayment:** To qualify for the IBR, borrowers 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) 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 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.

The IBR payment is recalculated annually based on household income. Married borrowers who file separate tax returns may have their IBR payments based on their respective incomes and still may count each other and any dependents in the family size. Borrowers who elect the IBR must sign a consent form authorizing the disclosure of their tax information and must recertify their family size on an annual basis. A borrower may contact their lender at any time if they experience a change in financial circumstances that could impact their required IBR payment and submit alternative documentation of income other than their reported AGI on the federal tax return. The IBR repayment

period is 25 years. At the conclusion of the 25-year repayment period, any remaining balance is forgiven.<sup>3</sup>

**2. Income Contingent Repayment:** Like the IBR, the ICR 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 ICR payment is \$0. The ICR is available to PLUS loan borrowers and also to borrowers who have defaulted loans in the Ford Program. The ICR is always based on household income. After 25 years, any balance that is remaining is forgiven by the Secretary of Education.

**3. 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 agencies, tribal nations, 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).

**C. 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).

**D. Suspension of Payments:** In addition to the different types of repayment plans, borrowers may seek deferment of repayment or forbearance. During certain deferment periods, 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 when the forbearance expires. 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.

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<sup>3</sup> Under the Internal Revenue Code, student loan debt forgiven at the end of the ICR or IBR 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. There is legislation currently pending that would specifically exclude debt forgiven under an income-based repayment plan (IBR or ICR) from taxability.

**IV. 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).

**V. WEB SITES**

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

Finaid (consumer financial aid website): ([www.finaid.org](http://www.finaid.org))

Department of Education ([www.ed.gov](http://www.ed.gov))

Department of Education Ombudsman Office ([www.ombudsman.ed.gov](http://www.ombudsman.ed.gov))

William D. Ford Direct Loan Program ([www.loanconsolidation.ed.gov](http://www.loanconsolidation.ed.gov))

National Student Loan Data System ([www.nsls.ed.gov](http://www.nsls.ed.gov))

ED PIN website: ([www.pin.ed.gov](http://www.pin.ed.gov))

National Counsel of Higher Education Loan Programs ([www.nchelp.org](http://www.nchelp.org))

Educational Credit Management Corporation ([www.ecmc.org](http://www.ecmc.org))

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

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

**VI. CONTACT INFORMATION**

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

**Edward M. (“Ted”) King**

**Frost Brown Todd LLC, Louisville, Kentucky**

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**Edward M. (“Ted”) King<sup>1</sup>**

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.

<sup>1</sup> 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](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 nonborrower 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 =  $AGI - (1.5 \times \text{Poverty Level for Family Size})$

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](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 postdischarge 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, tribunal nation, 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](http://www.finaid.org))

Department of Education ([www.ed.gov](http://www.ed.gov))

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