

Litigation under Sect. 523(a)(8): What Proofs Are Needed? Evidence Demonstration

Prof. Susan E. Hauser

North Carolina Central University School of Law; Durham, N.C.

Hon. Laurel M. Isicoff

U.S. Bankruptcy Court (S.D.Fl.); Miami

Rand Gelber, Esq.

The Law Offices of Rand L. Gelber; Rockville, Md. Speaker Affiliation; Speaker Location

STUDENT LOAN LITIGATION IN BANKRUPTCY

Rand Gelber, Esq.
Prof. Susan Hauser
Hon. Laurel Myerson Isicoff
Nov. 15, 2013

DEVELOPMENT OF § 523(A)(8)

- Before 1976, student loans were dischargeable.
- 1976: Most government-backed student loans made nondischargeable for 5 years after due date, unless undue hardship proven.
- 1984: Addition of private loans funded or guaranteed by a governmental or nonprofit entity.
- 1990: 5 year period increased to 7 years.
- 1998: 7 year period eliminated, leaving undue hardship as the sole basis for discharge.
- 2005: Private loans made nondischargeable, even when not backed by a governmental entity.

SECTION 523(A)(8) TODAY

- Section 523(a)(8) excludes public and private student loans from discharge unless:
- “excepting such debt from discharge . . . would impose an undue hardship on the debtor or the debtor’s dependents.”

LOANS WITHIN 523(A)(8)

- 523(a)(8)(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.”
- 523(a)(8)(ii): “an obligation to repay funds received as an educational benefit, scholarship, or stipend; or”
- 523(a)(8)(B): “any other educational loan that is a qualified education loan, as defined in § 221(d)(1) of the Internal Revenue Code ..., incurred by a debtor who is an individual.”

“EDUCATIONAL” LOANS

- To fall within the scope of § 523(a)(8), a debt must be an *educational* loan.
- Not every debt connected to education is an “educational” loan.
 - § Tuition
 - § Post-graduate “buy-out” loans
- To determine the “educational” character of a loan, most courts apply a “substance of the transaction” test that looks to the purpose of the loan transaction, and not to the use to which the debtor puts the funds.

SECTION 523(A)(8): UNDUE HARDSHIP

- The Majority Test: Brunner v. New York State Higher Education Services Corp., 831 F.2d 395 (2d Cir. 1987).
 - § Three-prong test.
 - § Adopted in the Third, Fourth, Fifth, Sixth, Seventh, Ninth, Tenth, and Eleventh Circuits.
- The Totality of the Circumstances Test: Eighth Circuit and bankruptcy courts in the First Circuit.
 - § Long v. Educ. Credit Mgmt. Corp. (In re Long), 322 F.3d 549 (8th Cir. 2003); Walker v. Sallie Mae Servicing Corp. (In re Walker), 650 F.3d 1227 (8th Cir. 2011).

THE TOTALITY OF CIRCUMSTANCES TEST

- The court considers:
 - (1) the debtor's past, present, and reasonably reliable future financial resources;
 - (2) a calculation of the reasonable living expenses of the debtor and her dependents; and
 - (3) "any other relevant facts and circumstances surrounding each particular bankruptcy case."

THE BRUNNER TEST

- To establish undue hardship, the debtor has the burden of proving:
 - (1) she cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans;
 - (2) 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) she has made good faith efforts to repay the loan.

CRITICISM OF BRUNNER

- Roth v. Educational Credit Management Corp. (In re Roth), 490 B.R. 908 (9th Cir. BAP 2013), Pappas, J., concurring.
- Brunner “is too narrow, no longer reflects reality, and should be revised.”
- 1. “Significant changes in the statutory landscape” since 1987.
 - – In 1987, student loans were dischargeable five years after the loan first became due.
 - – Expansion in loans covered by the statute.
- 2. Educational borrowing has changed drastically since 1987.

PARTIAL DISCHARGE

- Allows the debtor to discharge PART of his student loan debt, while remaining obligated to repay the remainder.
- Allowed in the Sixth, Ninth, Tenth, and Eleventh Circuits, as well as some bankruptcy courts in other circuits.
- Theories:
 - (1) The Brunner or totality of the circumstances test is applied to part of the debt.
 - (2) Section 105(a)
- Disallowed in the Third Circuit and many bankruptcy courts.

RECENT CASE LAW

- Krieger v. Educ. Credit Mgmt. Corp., 713 F.3d 882 (7th Cir. 2013).
- Good faith prong of the Brunner test does not require the debtor to agree to a deferred repayment schedule.
- Bankruptcy judge's factual finding that debtor's "straitened circumstances are likely to persist indefinitely" was approved.
- "A judge asked to apply a multi-factor standard interpreting an open-ended statute necessarily has latitude; the more vague the standard, the harder it is to find error in its application."

RECENT CASE LAW

- Hedlund v. Educ. Resources Inst., Inc., 718 F.3d 848 (9th Cir. 2013).
- The bankruptcy court's factual findings relative to good faith under Brunner are entitled to the deferential clear error standard of review.
- Any questions of law encompassed within the good faith determination are subject to de novo review.

INCOME BASED REPAYMENT PLANS

- One point of view: Debtor cannot show good faith under Brunner unless she enters such a plan.
- This is not supported by case law.
- No per se rule requiring the debtor to enter ICR/IBR plan to show good faith.
 - – Tirch, 6th Cir. 2005.
 - – Mosley, 11th Cir. 2007.
 - – Krieger, 7th Cir. 2013.

INCOME BASED REPAYMENT PLANS

- Another way to look at it: Is it possible for a debtor to show undue hardship if her payment is greatly reduced (potentially to zero) because she has entered into such a plan?
- No per se requirement coming from circuit courts.
 - – ICRP/IBR Plans are a factor for the court to consider.
- “Placing undue weight on the debtor’s ability to qualify for ICRP improperly limits the inherent discretion afforded to bankruptcy judges.” *ECMC v. Jespersen*, 571 F.3d 775 (8th Cir. 2009).

PROCEDURAL REQUIREMENTS

- Adversary needed
- Not in a Chapter 13 Plan

TIMING

- In a Chapter 7
 - § Often months if not years after Ch 7 filed– later ones, case needs to be reopened by motion.
- In a Chapter 13
 - § Should be filed at or near the end of the plan completion.
 - § If early in plan, motion to stay case or to dismiss as not ripe.
 - § Reasoning is that Court should have a clear picture of Debtor's financial situation.
 - § If early in plan, not likely that plan will go to completion and cant get the student loans discharged if there is no general discharge.

COMPLAINT

- Try to list as Defendants the holder and or guarantor; not the servicer or the original lender.
- Most cases are filed with the wrong defendants.
 - § In that case, a motion for substitution or for joinder is needed.
- Most complaints are not very specific so if you are one of the Defendants, you want to get discovery out right away so you can try and flush out the issues and the facts supporting the issues.
- Discovery not very useful for Plaintiff unless there are issues related to the loans or the servicing.
- 26(f) reports– Initial disclosures–
 - § Useful to get the loan information to Plaintiff such as notes, assignment, balances.
 - § Often times it helps Plaintiff to understand the loan balances and the type of loans to determine options available.

ISSUES

- Financial–
 - § This is the majority of cases– No job, low paying job (underemployed).
- Focus on income and expenses–
 - § Reasonable expenses
- Look at the trend in income–
 - § Going up, down or steady
- Unemployed–
 - § Efforts at finding employment, in field and outside of field
- Tax returns and refunds–
 - § Look to the use of the refunds– often times significant refunds
 - § On income analysis, amortize refund and add to monthly income
- Underemployed–
 - § Consider a vocational expert if the loan balance and other factors warrant it.

HEALTH ISSUES

- Expert opinion required to show their inability to work indefinitely.
 - § Can't rely on medical records and reports without testimony from doctor.
- Alternatives to trial witnesses—
 - § Use of depositions but still costly

REPAYMENT OPTIONS

- Once you can establish Debtor's income, you can send a letter with the various repayment options under the FORD program.
- You can also use the letter as evidence at trial of Debtor's knowledge of the program and the various repayment options to address Prong 3 of Brunner.

PRETRIAL MEMORANDUM

- Very effective tool in laying out the case for the trial judge from a fact standpoint and on the law if judge does not have experience handling student loan discharge cases.
- Helps the judge to focus on the issues at trial and helpful to counsel in preparing and trying the case.

TRIAL WITNESSES

- Plaintiff–
 - § Plaintiff and any witnesses supporting arguments
- Defendants–
 - § Plaintiff,
 - § Spouse,
 - § Defendant's representatives or custodian of records, and
 - § Any of Plaintiff's witnesses

TRIAL EXHIBITS

- Plaintiff–
 - § Documents supporting income and expenses, not just bankruptcy schedules. Loan information including balances, Other documents to support issue in case such as medical, job efforts,
- Defendant–
 - § Notes, assignment of notes, documents showing balances, discovery responses, tax returns, bankruptcy petition and schedules, including I and J, FORD letter. Avoid putting in any medicals unless it supports. Can always use outside documents to impeach.
- In 4th Circuit courts, exhibits are deemed admitted if timely submitted and not objected to by other party.
- From Defendant's standpoint, I usually file an objection to Plaintiff's exhibits to the extent that they are hearsay or offer a medical opinion.

CHAPTER 13

STUDENT LOANS AND THE CHAPTER 13 PLAN

CLASSIFYING STUDENT LOANS

- CLASSIFICATION RULES APPLY IN CHAPTER 13

- § Only substantially similar claims may be classified together

- § Substantially similar claims may be classified separately

- § If claims are separately classified the debtor may not “discriminate unfairly” among the separate classes

UNFAIR DISCRIMINATION “DEFINED”

- LOTS OF TESTS!!!!

- § *In re Orawsky*, 387 B.R. 128 (Bankr. E.D. Pa. 2008)

- THE BENTLEY TEST (*In re Bentley*, 266 B.R. 229 (1st Cir. BAP 2001))

- § **Equality of distribution** reflects the general expectation that, absent an express grant of priority, unsecured creditors will share equally in any dividend.

- § **2. Nonpriority of student loans** incorporates the notion that the Code does not grant student loans priority status. The baseline expectation here is simply that nothing in the Code mandates treating student loans more favorably than general unsecured claims

- § **3. Contributions: mandatory v. optional** expresses the chapter 13 requirement that a debtor devote all of his or her projected disposable income to a plan if the plan does not pay the full amount of allowed unsecured claims. The expectation emanating from that requirement is that unsecured creditors would share pro rata from distributions funded with the debtor's mandatory contributions.

- § **4. A fresh start for honest debtors** is one of the Bankruptcy Code's fundamental purposes. This baseline is tempered against the notion that Chapter 13 does not contemplate that debtors “will necessarily emerge from Chapter 13 entirely free of student loan obligations.”

UNFAIR DISCRIMINATION “DEFINED” CONTD.

- THE LESER/WOLFF TEST

- § Whether the discrimination has a reasonable basis
- § Whether the debtor can carry out a plan without the discrimination
- § Whether the discrimination is proposed in good faith
- § Whether the degree of discrimination is directly related to the basis or rationale for the discrimination

Mickelson v. Leser (In re Leser), 939 F. 2d 669 (8th Cir. 1991); *Amfrac Distrib. Corp. v. Wolff (In re Wolff)*, 22 B.R. 510 (9th Cir. BAP 1982).

UNFAIR DISCRIMINATION “DEFINED” CONTD.

- THE “OBSCENITY TEST” (CASE BY CASE)

- § “[T]he facts and circumstances of each case dictate whether the proposed discrimination is unfair.” This requires a fair balancing of “(1) The Debtor’s fresh start; (2) the clear legislative objective of student loan repayment; and (3) fair treatment of creditors as a whole.”

In re Harding, 423 B.R. 568, 574–575 (Bankr. S.D. Fla. 2010)

- § “In determining whether any such discrimination is fair or not, courts consider various factors, applied to the circumstances of each particular case. These factors are variously formulated but bear upon the equitable allocation of plan resources and the furtherance of underlying policy objectives.”

In re Machado, 378 B.R. 14, 16 (Bankr. D. Mass.2007)

SEPARATE CLASSIFICATION OF STUDENT LOANS

DIFFERENT TREATMENT IS NOT UNFAIR DISCRIMINATION

§ The Debtor is an above–median debtor and the payment to the student loan lender is from “excess income” (all PDI is being paid to unsecured creditors).

See, e.g., In re Abaunza, 452 B.R. 866 (Bankr. S.D. Fla. 2011)

§ There is a benefit to the other creditors for the separate treatment (e.g., if student loan is not paid on time the debtor could lose her professional license necessary to work and make her plan payments).

See, e.g., In re Harding, 423 B.R. 568 (Bankr. S.D. Fla. 2010)

SEPARATE CLASSIFICATION CONTD.

§ The student loan is a long term loan and the Code allows separate classification (but NOTE other cases hold that the debtor must still show different treatment is not unfair)

Compare Labib–Kiyarash v. McDonald (In re Labib–Kiyarash), 271 B.R. 189 (9th Cir. BAP 2001) *with In re Truss*, 404 B.R. 329 (Bankr. E.D. Wis. 2009).

DIFFERENT TREATMENT IS UNFAIR DISCRIMINATION

- Different treatment only because the student loan is NOT dischargeable constitutes unfair discrimination

§ But the non–dischargeability of the loan may be a factor to be considered

STUDENT LOANS AND THE COST OF CHAPTER 13

- Student loans accrue regular interest plus late fees, penalties, collection fees and default rate interest if the student loan is not paid on time and in the required monthly amount.

§ When the Chapter 13 case is over, the student loan debt may even be higher than when the case was filed.

§ This result is inconsistent with the purpose of the Bankruptcy Code (fresh start) and the 2005 BAPCPA push to Chapter 13 rather than Chapter 7

PROTECTING THE “CODE”

- Accrual of any charges other than the contract rate of interest (e.g. late fees, penalties, collection fees, or default interest) during the chapter 13 case is a violation of the automatic stay AND any attempt to collect anything other than the accrued contract rate of interest after the Chapter 13 case is concluded is a violation of the discharge injunction.

In re Harding, 423 B.R. 568 (Bankr. S.D. Fla. 2010); see *In re Boscaccy*, 442 B.R. 501 (Bankr. N.D. Mass. 2010)