Bankruptcy, Out-of-Court Options and the Student Loan Debt Problem

The Easy Fix: Is Repealing § 523(a)(8) Really the Answer?

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Talking Points for Discussion

Would repealing the discharge exception for student loan indebtedness provide an easy answer to the problems of over-indebted graduates? To answer this question, it is necessary to evaluate the function of the undue hardship standard of Section 523(a)(8) and to consider what any amendment or repeal of this standard would, and would not, accomplish. These talking points outline the issues the panelists will discuss in making this evaluation and in considering what non-statutory reforms might more broadly address the problems of student loan indebtedness.

I. Function of Undue Hardship Standard

Whereas other panels focus on what the undue hardship standard actually means, this discussion will focus on what this standard does. Fundamentally, it is helpful to understand that bankruptcy law in general serves to provide debt forgiveness to the "honest but unfortunate debtor." In the student loan context, this means that bankruptcy serves to forgive the student loan debts of those debtors with no chance of repaying those debts from those debtors than can repay them, in full or in part. When attempting to separate the can't-pay from the can-pay debtors, two types of errors are possible. The first type of error would be to grant a discharge to an undeserving debtor, i.e., to forgive the student loan debts of a borrower that can actually afford to repay those loans. The second type of error would be to deny a discharge to a deserving, "can't-pay" debtor.

The undue hardship standard in Section 523(a)(8) has been justified, in part, as an effective means to reduce the first sort of error, making it difficult for an undeserving debtor to discharge his or her student loans. Our discussion will begin by considering (1) whether bankruptcy law should be particularly sensitive to the risks of granting a discharge to "can-pay"

debtors and (2) whether the undue hardship standard is needed to prevent such errors. Bankruptcy law, of course, will inevitably make some errors, as any standard requires a prediction about a debtor's future ability to repay his or her loans. Accordingly, our discussion will then consider whether administrative relief might provide superior solutions to student loan problems and whether agency-based or rule-based reforms might improve upon current administrative remedies.

A. Evaluating Undue Hardship

Is there any reason to believe that the undue hardship standard would do a better job than a "good faith" standard?

A principally asserted virtue of the undue hardship standard is that it deters bankruptcy filings by opportunistic debtors. If Congress were to repeal Section 523(a)(8), student loan debts would be automatically dischargeable, subject only to the Code's good faith requirements.

Such a change, it is feared, might invite more borrowers into bankruptcy, thereby imposing costs on other borrowers. At the same time, there is concern that the undue hardship standard may be denying bankruptcy relief even when there is little likelihood the debtor will ever be able to repay his or her loans. Further, even if a shift to a good faith standard might initially encourage more bankruptcy filings, some contend that there is no reason to believe a court could not both detect the opportunistic filers and grant relief to those with little ability to ever repay.

What costs might a shift to a good faith standard impose on debtors, creditors, and the bankruptcy courts?

The undue hardship standard places the burden of seeking a discharge on the student loan borrower. The student loan debtor must initiate an adversary proceeding to discharge the student loan debt. The creditor then has the duty to establish the validity of the debt and that it falls

under Section 523(a)(8). At that point, the burden then shifts back to the debtor to establish that repaying the debt poses an undue hardship.

If Section 523(a)(8) were repealed, a debtor in Chapter 13 would have the burden of establishing good faith in order to confirm a plan under Section 1325(a)(3). In Chapter 7 cases, on the other hand, the debtor would be absolved of the burden-of-proof that currently exists to discharge student loans. The burden would shift to the student loan creditors, who would be forced to bring an abuse dismissal motion under Section 707(b)(1) on the basis that the debtor filed the petition in bad faith and to meet the burden of proof. This would impose increased monitoring costs on student loan creditors.

Some posit that these increased costs for student loan creditors are similar to the monitoring costs faced by other creditors, as creditors generally have the burden of raising discharge objections. On the other hand, if there are reasons to believe this burden shift would result in unusually high costs in the student loan context, then we may have concerns about how those costs might impact other students' access to credit.

The benefits from such a shift might include the granting student loan discharges for more "can't-pay" debtors. The risk, of course, would be that such a system might also grant relief to some "can-pay" debtors and might encourage more debtors to file bankruptcy for the primary purpose of discharging their student loan debts.

A shift to a good faith standard might also be expected to increase the costs of bankruptcy administration. Because creditors would bear the burden of litigating discharge exceptions, we might expect more adversary proceedings on discharge exceptions than we see under the current undue hardship standard. We might also consider the burdens such a shift would place on bankruptcy judges to review whether debtors' petitions were filed in good faith.

Whether a shift to a good faith standard would ultimately provide benefits that would outweigh the costs, we can expect that even an ideal bankruptcy standard would make some mistakes, as it is impossible to perfectly predict which debtors will ultimately be able to re-pay their debts. This leads to the question of whether non-bankruptcy forms of relief might be better able to account for this problem by placing debtors into a longer term repayment plan that would be based on their ability to repay, either in full or in part, thus removing the need to predict the debtor's future ability to pay.

II. Non-Statutory Reforms

Would an administrative remedy (e.g., adjusting repayments to borrower's ability or other remedies already discussed by other panels) generally be a more effective way of handling student loan indebtedness?

One might imagine that administrative remedies might do a better job of ensuring that debtors pay as much as they can towards their student loan debt. Income-based repayment plans and other administrative discharges (e.g., a total-and-permanent-disability discharge) can provide a means for relieving debtors of overly burdensome student loan debt while at the same time ensuring debtors repay within their capacity, all without the need of having to make predictions regarding the debtor's future ability to repay.

If such administrative remedies are in fact preferable to bankruptcy, then we might consider whether student debt relief should be available in bankruptcy. Excepting such debt from discharge might encourage debtors into these preferred programs. At the same time, for those debtors with no ability to repay at all, based upon current circumstances, any administrative remedy might be a pointless waste of resources.

Undue Hardship's Function and Failings

Might the undue hardship standard serve an important role in discouraging the capable debtors from seeking bankruptcy relief, steering them instead into income-based repayment programs and the like?

One might consider that the undue hardship standard might discourage debtors from seeking bankruptcy relief in order to address their student loan indebtedness. If this is true, then one might consider (a) whether this function justifies the risks of denying discharges to "can't-pay debtors" and (b) why debtors are looking to bankruptcy before they are looking to other administrative remedies.

Why aren't borrowers getting into these alternative payment plans before hiring a bankruptcy lawyer or actually filing an undue hardship action?

If we think the ideal system would be to discharge student debts for those with no hope of repaying anything and to modify payments for those who can pay something, then the problem may not be with bankruptcy law but with financial literacy and education about student loan repayment options. There are currently many options available for borrowers to modify their indebtedness, but each of these may come at certain costs, including the entry costs of learning about and applying for such programs.

Is there something about current administrative remedies that could be improved to make these remedies more attractive?

One might imagine a number of obstacles that prevent borrowers from attempting to modify their indebtedness. Debtors may be unaware of these resources. They may undervalue such resources. Or they may overestimate their chances of receiving a discharge under the Bankruptcy Code.

One such obstacle may be that the cancellation of indebtedness at the end of an administrative remedy might count as taxable income under the Internal Revenue Code. Discharge of indebtedness is generally counted as income under Section 61(a)(12) of the IRC; however, discharge of indebtedness is not income if "the discharge occurs when the taxpayer is insolvent," under Section 108(a)(1)(B). Thus, to the extent borrowers are insolvent at the time their student loan debt is discharged through an administrative remedy, there would be no cost to the government from amending the tax code to exclude the discharge of student loan debt. And more importantly, there would be no tax impact on the borrower. There might not be "real" benefit to borrowers, but perhaps there would be a psychological benefit to debtors, as they might perceive there to be a lower cost to administrative remedies.

Are there are other agency-based reforms or rule-based reforms that might help alleviate the problems of student loan indebtedness?

To some extent, there are informational barriers to administrative remedies. Under the current system, who bears the responsibility of educating borrowers? And should this be addressed through agency-based or rule-based reforms?

Where do bankruptcy filers frequently get information about repayment programs? What are the costs and benefits of this current approach? And how might this approach be changed through agency-based or rule-based reforms?

Under the current system, one might imagine that a debtor's attorney might serve this role of advising clients of repayment options. But consumer bankruptcy attorneys may be constrained from doing so or lack the information themselves. If the answer is not consumer bankruptcy attorneys, it may be that the only party knowledgeable about loan repayment options is the student loan creditor. Student loan creditors are the repeat players in these actions and

may, therefore, have superior knowledge. But it is an odd situation in which student loan creditors are expected to not only defend against debtors' efforts to discharge their student loan debts and at the same time provide debtors with information about alternative repayment options. That being said, in some instances, that is exactly what happens today.