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The Devil's Undue: Student Loan Discharge in Bankruptcy, the Undue Hardship Standard, and the Supreme Court's Decision in *United Student Aid Funds v. Espinosa*

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The Devil's Undue: Student Loan Discharge in Bankruptcy,

the Undue Hardship Standard, and the Supreme Court's Decision in

United Student Aid Funds v. Espinosa

by Kerry Brian Melear*

I. INTRODUCTION

"The primary purpose of the Bankruptcy Code is

to grant a fresh start to the honest but unfortunate debtor."[1]

Debtors holding both federally financed and privately issued student loans who file bankruptcy cannot discharge these obligations absent a showing of "undue hardship," reached through an adversary proceeding, as outlined in federal law.[2] Student loans were exempted from bankruptcy discharge without demonstration of undue hardship in the 1970s in an effort to circumvent attempts to finance university studies and then discharge the obligation in a bankruptcy proceeding. The undue hardship standard has long been

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[1] *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365, 367 (2007).

[2] 11 U.S.C. § 523(a)(8) (2010).

debated, and federal bankruptcy law surrounding the discharge of student loan obligations has shifted over time.

Issues surrounding student financial aid remain at the forefront of public policy concerns in light of the weakened economy and strained employment prospects during a period of increased enrollment in higher education, especially in the for-profit sector.[3] In September 2010, U.S. Secretary of Education Arne Duncan announced that the student loan default rate during the 2008 fiscal year increased to seven percent.[4] The data underlying this announcement highlight the difficulty borrowers face in repaying loans during difficult economic times, and also indicate that students attending for-profit institutions are the most likely to default.[5] Increases in student lending, coupled with an increasing default rate, are important policy concerns for higher education administrators and counsel, particularly at a time when institutional budgets are under tremendous strain.

According to the Administrative Office of the United States Courts, during the twelve-month period ending September 30, 2010, over 1.5 million individuals filed

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[3] *See* Erica R. Hendry, *For-Profit Colleges See Large Increases in Enrollment and Revenue*, CHRON. HIGHER EDUC., August 25, 2009.

[4] United States Department of Education, *Student Loan Default Rates Increase: Borrowers At For-Profit Schools Represent Large and Growing Share of Loan Defaults,* September 13, 2010, *available at* http://www.ed.gov/news/press-releases/student-loan-default-rates-increase-0. The default rate at some institutions may increase because of an error in Department of Education data collection procedures. *See* Kelly Field, *Education Dept. Has Undercounted Student-Loan Defaults in Its Monthly Reports*, CHRON. HIGHER EDUC., November 17, 2010.

[5] *Id.*

bankruptcy petitions under Chapters 7 and 13.[6] Further, from 2006-2010, over 5.2 million individuals have filed bankruptcy petitions under Chapter 7 or Chapter 13.[7] Debtors who seek to discharge either publicly or privately held student loans are directed to demonstrate how repayment would create an undue hardship in order to meet with success under federal law. The nebulous determination of undue hardship for the "honest but unfortunate debtor,"[8] however, remains problematic.[9]

According to *The Chronicle of Higher Education*, in 2008 the Education Credit Management Corporation, which services loans for twenty-five lending agencies and the United States Department of Education, held 72,000 loans in bankruptcy proceedings. In that year, 276 debtors sought to have student loans discharged. By November 2009, 134 of the cases had been resolved, and only twenty-nine of those cases directed that student loans should be totally or partially discharged.[10]

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[6] During the twelve months ended September 30, 2010, individuals filed 1,105,033 Chapter 7 petitions and 430,583 Chapter 13 provisions. *Administrative Office of the U.S. Courts*, *Bankruptcy Statistics*, *available at* http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx.

[7] From January 2006 to October 2010, 3,501,713 individuals filed Chapter 7 bankruptcy petitions and 1,700,049 individuals filed Chapter 13 bankruptcy petitions. *See Bankruptcy Data Project at Harvard*, *available at* http://dbp.law.harvard.edu.

[8] *Hanover Natn'l Bank v. Morpes*, 186 U.S. 181, 192 (1902).

[9] *See* Robert C. Cloud, *Offsetting Social Security Benefits to Repay Student Loans: Pay Us Now Or Pay Us Later*, 208 ED. LAW REP. 11 (2006).

[10] Eric Kelderman, *Supreme Court Considers Case About Excusing Student Debt Through Bankruptcy*, CHRON. HIGHER EDUC., November 29, 2009. The author contacted the Education Credit Management Corporation (ECMC) to request updated statistics in October 2010. ECMC was unable to provide updated statistics, but confirmed these figures.

In 2010, the United States Supreme Court rendered an opinion in *United Student Aid Funds v. Espinosa*[11] that visited the concept of undue hardship, but more narrowly focused on the procedural rules through which courts analyze bankruptcy proceedings. Prior to *Espinosa*, bankruptcy courts and federal circuits differed in opinion as to the discharge of student loan obligations that were not pursued strictly under the Bankruptcy Code.[12] Bankruptcy cases are, by nature, individual and fact-specific, and appellate courts have rendered various decisions as to whether discharges of student loans were permissible without demonstration of undue hardship in an adversary proceeding, as required by the Bankruptcy Code. In the decision, the Supreme Court affirmed the discharge of a debtor's student loans, which had been discharged by a bankruptcy court without a determination of undue hardship. The Court couched the discharge of the loans without a showing of undue hardship in an adversary proceeding as legal error, but upheld it because the creditor had notice of the proposed bankruptcy plan and did not timely object, among other issues.

The Supreme Court's opinion in *Espinosa* did not clarify the undue hardship standard, which would have been preferred by the legal and academic communities, but this was not expected given the procedurally-focused question facing the Court. However, the decision did open a small window into a new opportunity for debtors to forego an adversary proceeding if the lender agrees to a reorganized payment plan determined on the basis of undue hardship. Questions remain as to what that standard entails, but the potential impact on student loan discharge rates in bankruptcy could be

[11] 130 S.Ct. 1367 (2010).

[12] 11 U.S.C. § 523(a)(8) (2010).

significant. Higher education administrators, counsel, and public policy-makers should be aware of the fundamentals of student loan discharge in bankruptcy, particularly given the potential for litigation surrounding the tremendous amount of financial aid distributed and an ever-increasing rate of default on those loans. As noted by Helms and Jorgensen, bankruptcy claims are among the most numerous facing higher education in the federal courts.[13] They caution that the "[v]olume and complexity of federal regulations and statutes addressing student financial assistance are an increasing source of litigation which often directly involves institutions in the dispute."[14]

This article briefly outlines the structure of federal bankruptcy law, the undue hardship standard articulated by Congress, as well as the judicial tests that have been developed by the courts to reach a determination of undue hardship. The article then details recent exemplar cases in which debtors have successfully established undue hardship required to discharge student loans or failed to do so. In the final section, the Supreme Court's decision in *Espinosa* is explored and discussed.

II. BRIEF OVERVIEW OF FEDERAL BANKRUPTCY LAW

This section provides a brief overview of federal bankruptcy law, as well as the additional procedures necessary to discharge student loan debt requiring a showing of undue hardship in repayment. While currently private student loans and government subsidized loans both require a showing of undue hardship to discharge, legislation has

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[13] Leila B. Helms and James D. Jorgensen, *Patterns of Litigation and Higher Education: 2007 In Perspective*, 245 ED. LAW REP. 537 (2007).

[14] *Id.* at 547.

been filed to return privately held student loans to a category of debt discharged without requiring an adversary proceeding and demonstration of undue hardship. At this writing, this dispute is beyond the scope of this article because loan obligations of both types currently require a showing of undue hardship to discharge, but the issue is at the forefront of a public policy discussion.[15]

A. The Bankruptcy Code

Bankruptcy is a process intended to mitigate the effects of severe financial distress on the honest but unfortunate debtor, offering "the possibility of a fresh start through the bankruptcy discharge, as well as an ability to restructure their debts in certain circumstances."[16] The term bankruptcy "[d]erives from the medieval Italian custom of breaking the benches of a banker or merchant who absconded or left creditors unpaid."[17] Bankruptcy courts review bankruptcy petitions under Article I of the Constitution, which empowers Congress to establish uniform bankruptcy law in the United States.[18] The

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[15] The Bankruptcy Code was amended in 2005 to require debtors to demonstrate undue hardship to discharge privately held student loans, which had been previously treated as any other private debt, such as credit card or mortgage debt. The increase in private lending associated with for-profit universities as well as student lending to accommodate for the differential between federal student loans and tuition has engendered a renewed discussion in the public sector and Congress about the discharge of privately held loans in bankruptcy proceedings. *See* Jennifer Epstein, *Rethinking Bankruptcy and Student Loans*, September 24, 2009, *available at* http://www.insidehighered.com; Andrea Fuller, *Lawmakers Introduce Bills to Change Student-Loan Bankruptcy Policy*, CHRON. HIGHER EDUC., April 22, 2010.

[16] 1 COLLIER ON BANKRUPTCY, ¶ 1.01[1] (16th ed. 2010).

[17] Douglas G. Baird, ELEMENTS OF BANKRUPTCY 4 (4th ed. 2006).

[18] U.S. Const. art. I, §8. *See* David G. Epstein, Bruce A. Markell, Steve H. Nickles, & Elizabeth L. Perris, BANKRUPTCY: 21ST CENTURY DEBTOR-CREDITOR LAW 668 (2d ed. 2006).

federal Bankruptcy Code provides a framework in Title 11 of the *United States Code*[19] that should be followed by the debtor in order to discharge a federal student loan obligation.[20] This relief falls in one of two forms: liquidation of assets under Chapter 7,[21] or reorganization of debt under Chapter 13.[22] To discharge student loan obligations, individual debtors must file for bankruptcy under Chapter 7 or Chapter 13 of the Code, and then pursue an additional adversary proceeding in which the undue hardship that repayment of the obligation would place on the debtor must be proven in order to discharge student loan debt.[23]

Pursuant to 28 USCA Section 2075, the United States Supreme Court has established the Federal Rules of Bankruptcy Procedure[24] (the Rules), which govern the procedures followed in federal bankruptcy courts rather than the Federal Rules of Civil Procedure.[25] The Bankruptcy Rules are particularly salient in the context of the discharge of student loan obligations, as they direct the additional procedures necessary to effect

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[19] 11 U.S.C. §§ 101-1532 (2010).

[20] 1 COLLIER ON BANKRUPTCY, ¶ 1.07[1] (16th ed. 2010).

[21] *See infra* text accompanying notes 32-33.

[22] *See infra* text accompanying note 34.

[23] Public universities have challenged these adversary proceedings on the basis of sovereign immunity. The Supreme Court, however, concluded that student loan discharge does not implicate sovereign immunity and that bankruptcy courts have authority to make a determination of undue hardship that is binding on the state. *See Central Virginia Community College v. Katz*, 546 U.S. 356 (2006) and *Tennessee Student Assistance Corporation v. Hood*, 541 U.S. 440 (2004). For in-depth discussion, *see* William A. Kaplin and Barbara Lee, THE LAW OF HIGHER EDUCATION 844 (4th ed. 2006). *See also* Kenneth N. Klee, BANKRUPTCY AND THE SUPREME COURT 10-11 (2008).

[24] Fed.R.Bankr.P. 1001.

[25] Epstein, *supra* at 670.

such a discharge, such as articulating who should receive notice of a proposed bankruptcy petition or how much time interested parties will have prior to a bankruptcy court's action on a petition.[26] The Rules have been aptly couched as "often as important as the statutory provisions,"[27] and failure to adhere to the Rules led to the Supreme Court's decision in *Espinosa*.

The Bankruptcy Code is organized in nine chapters, six of which contain provisions offering bankruptcy relief for various types of debtors.[28] The Code specifies the various types of debtors who can seek relief under the various Chapters, which are odd-numbered so that the Code can be further expanded, such as the 1986 addition of Chapter 12, which provides for the adjustment of debts of family farmers or fishermen.[29] Chapters 1, 3, and 5 of the Code apply general provisions such as definitions and a framework to all Chapters.[30] Chapters providing debtor-relief mechanisms are: Chapter 7, Individuals and businesses seeking liquidation; Chapter 9, Bankruptcies for municipalities; Chapter 12, Family farmers or fishermen; Chapter 13, Individuals with regular income seeking reorganization of debt; Chapter 11, Business reorganizations; and Chapter 15: Cross-border (international) bankruptcies.[31] As noted, Chapters 7 and 13 are

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[26] 1 COLLIER ON BANKRUPTCY, ¶ 101[2][b] (16th ed. 2010).

[27] 1 COLLIER ON BANKRUPTCY, ¶ 101[2][b] (16th ed. 2010).

[28] 1 COLLIER ON BANKRUPTCY, ¶ 1.07[1] (16th ed. 2010).

[29] *Id*.

[30] 1 COLLIER ON BANKRUPTCY, ¶ 1.01[2][a] (16th ed. 2010).

[31] *See* THE SURETY AND BANKRUPTCY (J. Blake Wilcox et al. eds, 2010).

the primary vehicles under which individuals file and subsequently seek to discharge student loans.

B. Chapter 7 Bankruptcy: Liquidation

The Chapter 7 bankruptcy petition is the most commonly asserted by debtors.[32] In a Chapter 7 bankruptcy proceeding, all of the debtor's property that is considered non-exempt is liquidated, and those proceeds are then distributed to the various creditors. The debtor gives up non-exempted property at the time the bankruptcy petition is filed in hopes of receiving a discharge that relieves liability from pre-bankruptcy debts.[33]

C. Chapter 13 Bankruptcy: Reorganization

A Chapter 13 bankruptcy differs in scope from a Chapter 7 petition. Where the object of Chapter 7 is the liquidation of assets into cash at the time of filing, Chapter 13 considers future income in the reorganization of debt. In a Chapter 13 proceeding, the debtor maintains her assets while making payments according to a court-approved bankruptcy plan.[34] Creditors are to be provided of notice of the bankruptcy petition and attendant reorganization plan, including lending agencies holding student loan obligations that debtors seek to discharge. Student lending organizations are also to receive notice of the adversary hearing necessary to reach a determination of undue hardship on the debtor, which is required to discharge student loans under the Bankruptcy Code.

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[32] 1 COLLIER ON BANKRUPTCY, ¶.1.07[1] (16th ed. 2010).

[33] Epstein, *supra* at 672.

[34] *Id.*

III. THE UNDUE HARDSHIP STANDARD

The following section analyzes the undue hardship standard in detail and discusses recent cases in which debtors have met with success or failed to establish undue hardship necessary to discharge student loan debt.

A. Undue Hardship Defined in the Bankruptcy Code

As noted, student loan debt obligations are non-dischargeable in bankruptcy absent a showing of undue hardship derived through an adversary proceeding, the provision for which is promulgated in the Bankruptcy Code at 11 U.S.C. Section 523(a)(8):

> **Section 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 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;

Congress added this language to the Bankruptcy Code in 1978 to discourage excessive discharges of student loan obligations.[35] Because Congress did not provide a specific definition of undue hardship in the Code, bankruptcy courts are left to make that determination on a per-case basis. However, the standard is nebulous and left open to interpretation, and courts have generally embraced a three-prong test to reach determination of undue hardship.[36] Even this framework, however, creates a high bar, and the discharge of student loan obligations is often frustrated by the inability to meet the undue hardship threshold.[37]

B. The *Brunner* Test to Determine Undue Hardship

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[35] *See* Robert C. Cloud, *When Does Repaying a Student Loan Become an Undue Hardship?*, 185 ED. LAW REP. 783 (2004).

[36] *See* Craig Gaumer, *Chaos in the Courts: The Meaning of "Undue Hardship" in 11 U.S.C. § 523(a)(8) and the Argument for Establishing a Uniform Federal Standard*, 23-4 A.B.I.J. 8 (2004); *See also* B.J. Huey, *Undue Hardship or Undue Burden: Has the Time Finally Arrived for Congress to Discharge § 523(a)(8) of the Bankruptcy Code?*, 34 TEX. TECH. L. REV. 89 (2002).

[37] *See* Rafael I. Pardo & Michelle R. Lacey, *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 AM. BANKR. L.J. 179 (2009) (arguing, through extensive legal and statistical analysis, that the current discharge framework is inequitable for the honest but unfortunate debtor).

While several tests exist to reach a determination of undue hardship,[38] many courts have favored the use of the tripartite test articulated in 1987 by a federal bankruptcy court[39] and affirmed by the Second Circuit in *Brunner v. New York State Higher Education Services Corporation (In re Brunner)*.[40] In *Brunner*, the debtor received a bachelor's degree in Social Work in 1979 and then a master's degree in 1982.[41] Seven months after receiving her master's degree, she filed for bankruptcy under Chapter 7, and her outstanding debts were discharged, exclusive of $9,000 in student loans.[42] She later sought to discharge the student loan obligation, and, in a brief hearing, the judge dismissed the obligation in an oral ruling.[43] The New York State Higher

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[38] Other standards that have been employed by courts include the "Johnson Test" established in *PHEAA v. Johnson (In re Johnson)*, 5 Bankr. Ct. Dec. 532 (Bankr. E.D.Pa. 1979) (considering debtor's current and future ability to repay the obligation while maintaining a minimum standard of living), the "Totality of Circumstances" test articulated in *Andrews v. South Dakota Student Loan Assistance Corporation (In re Andrews)*, 661 F.2d 702 (8th Cir. 1981) (considering all factors related to a debtor's ability to repay the obligation on a per case basis), and the "Bryant Poverty Test" developed in *Bryant v. PHEAA (In re Bryant)*, 72 B.R. 913 (Bankr. E.D. Pa. 1987) (considering whether the debtor's net income exceeds the federal poverty line, in which case the debt is not dischargeable). *See* Bankruptcy and Financial Aid, *available at* http://www.finaid.org/questions/bankruptcy.phtml. *See also* Scott Pashman, Note, *Discharge of Student Loan Debt Under 11 U.S.C. § 523(a)(8): Reassessing 'Undue Hardship' after the Elimination of the Seven-year Exception*, 44 N.Y.L. SCH. L. REV. 605 (2001).

[39] 46 B.R. 752 [23 Ed. Law Rep. 573] (Bankr. S.D.N.Y. 1985).

[40] 831 F.2d 395 [42 Ed. Law Rep. 535] (2d Cir. 1987).

[41] *Brunner*, 46 B.R. 752, 753.

[42] *Id.*

[43] *Id.*

Education Services Corporation (HESC), the guarantor of the loans, appealed the decision.[44]

Absent a definition of the term "undue hardship" in the Bankruptcy Code, the appellate bankruptcy court posited that "the existence of the adjective 'undue' indicates that Congress viewed garden-variety hardship as insufficient excuse for a discharge of student loans, but the statute otherwise gives no hint of the phrase's intended meaning."[45] The term was used in a draft bill proposed by the Commission on the Bankruptcy Laws of the United States (the Commission) in the 1970s, and the Commission's report noted that its rationale was rooted in a marked increase in the number of former students filing for bankruptcy to avoid repaying student loan obligations.[46]

The bankruptcy court then analyzed standards for determination of undue hardship embraced by other courts, noting that most required a debtor to satisfy the minimal standard of living test, which held that the debt could only be discharged if repayment would cause the debtor's income to fall below a minimal level.[47] However, the court noted that predicting future income is a complex process: "Minimum necessary future expenses may be ascertained with some precision from an extrapolation of present needs, but unpredictable changes in circumstances such as illness, marriage, or childbirth

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[44] *Id*.

[45] *Id*. at 753.

[46] *Id*. at 754. *See* Report of the Commission on the Bankruptcy Laws of the United States, House Doc. No. 93-137, Pt. I, 93d Cong., 1st Sess. (1973).

[47] *Id.*

may quickly wreak havoc with such a budget. Even more problematic is the calculation of future income."[48]

Thus, the court found it reasonable that many more courts required more than just a showing that a debtor's current financial portrait could render repayment impossible, favoring an analysis that demonstrates that lack of ability to repay the obligation would extend over a considerable period of time.[49]

The court next noted that other courts had required a showing of good faith in repayment of loan obligations prior to permitting a discharge, finding that it is proper to require a debtor to demonstrate that he has made good faith efforts to repay students loans.[50] The court concluded that such a showing comports with the stated purpose of the Bankruptcy Code, which seeks to prevent students from abusing the bankruptcy system to shed their loan obligations.[51]

Having articulated and analyzed the rationales of other courts in determining undue hardship, the court then synthesized these findings into the now widely-accepted three prong *Brunner* test. In order to establish undue hardship under this standard, a debtor must establish that (1) the debtor cannot maintain a minimal standard of living, based on current income and expenditures, if required to repay the obligation; (2) such a

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[48] *Id*. at 754.

[49] *Id*. at 755.

[50] *Id.*

[51] *Id.*

state of affairs would persist for a substantial portion of the repayment period of the loan; and (3) the debtor has made a good faith effort to repay the loan.

In applying this framework to Marie Brunner's petition to discharge her student loans, the court concluded that, although she was presently unemployed and had experienced difficulty securing employment in her field, she had at most proved "that she is currently—or was at the time of the hearing—unable to meet her minimal expenses and pay off her loans. This alone cannot support a finding that the failure to discharge her loans will impose undue hardship. Nothing in the record supports a finding that it is likely that her current inability to find any work will extend for a significant part of the repayment period of the loan…."[52] The court also readily concluded that she failed to demonstrate a good faith effort to repay the loans, given that she filed for discharge within a month of the first payment due date, had made no attempt to repay the loans, nor did she request a deferment, a remedy available to those who are unable to pay because of extended unemployment.[53] Thus, the court reasoned that the discharge of her student loan obligation was erroneous and reversed the decision.[54]

In a brief opinion, the Second Circuit affirmed the decision and adopted the three-prong test, noting that many courts had embraced the first prong requiring a showing of minimal standard of living, but that the further requirements of prongs two and three, a prolonged period of financial difficulty caused by repayment and a showing of good

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[52] *Id*. at 757-758.

[53] *Id.*

[54] *Id.*

faith, were reasonable in light of "clear congressional intent exhibited in section 523(a)(8) to make the discharge of student loans more difficult than that of other nonexcepted debt."[55]

C. Recent Example Cases

The following section explores recent bankruptcy cases involving the undue hardship standard. These cases were selected for their analyses of various prongs of the *Brunner* test under which courts variously discharged or declined to discharge student loan obligations.

1. Undue Hardship Not Determined

While failing only one prong of the *Brunner* test is sufficient to preclude discharge of student loans, some debtors who seek discharge fail the test outright. In *Campton v. United States Depart. of Education (In re Campton)*,[56] an unemployed graduate filed an adversary proceeding against the U.S. Department of Education seeking to discharge his student loan obligation in the amount of $12,500. The court applied the *Brunner* test for undue hardship, which holds that the debt can be discharged only if the debtor proves the three elements previously discussed: (1) the debtor cannot maintain, based on current income and expenses, a minimal standard of living if forced to repay; (2) the debtor's state of affairs is likely to persist throughout a significant portion of the repayment period; and (3) the debtor has made a good faith effort to repay the loans. The

[55] *Brunner*, 831 F.2d 395, 396 (2d Cir. 1987).

[56] 405 B.R. 887 [245 Ed. Law Rep. 212] (Bkrtcy.N.D.Ohio 2009).

United States Bankruptcy Court for the Northern District of Ohio concluded that the debtor failed the first prong of the test, noting that his monthly expenditures for a boat, cable television, and cigarettes could capture the full repayment amount. The debtor failed the second prong because he offered no evidence that his unemployment would continue for a substantial portion of the repayment period. Finally, the debtor failed the third prong because his repayment history had been virtually non-existent, failing the good-faith analysis. The court concluded that the debtor was thus not eligible for a discharge of the debt because of any undue hardship it created.

Similarly, a debtor who filed for relief under Chapter 7 of the Bankruptcy Code sought to have her student loan debt discharged.[57] The debtor was a registered nurse working part-time, who garnered $80,000 in student loans to pursue her degree; however, only $25,000 of the money was actually used to pay tuition-related expenses, while the remainder was used for living expenses. The debtor had not paid toward her loans since they became due, and the debt at the time of the hearing accumulated to $111,000. However, the debtor and her husband possessed tangible assets and made a substantial annual income, even though she worked only part-time. She sought to have her educational debt discharged under the undue hardship exception, but the United States Bankruptcy Court for the Northern District of Ohio concluded that the debtors' financial resources, coupled with their ability to trim unnecessary expenses and work full-time, did not meet the burden required under the inquiry to determine eligibility for undue hardship

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[57] *Grant v. United States Dept. of Educ. (In re Grant)*, 398 B.R. 205 [240 Ed. Law Rep. 244] (Bkrtcy.N.D.Ohio 2008).

exceptions. The court also concluded that the debtor was ineligible for an equitable adjustment of the debt because the undue hardship standard had not first been met.

In *Hedlund v. Pennsylvania Higher Education Assistance Agency (In re Hedlund),*[58] the Ninth Circuit paid particular attention to the debtor's good faith effort (or lack thereof) to repay the obligation prior to seeking discharge. The debtor sought to discharge $85,000 in student loans accrued from attending law school. He never passed the bar exam, and had been working as a juvenile counselor. A federal bankruptcy court concluded that requiring him to repay loans in excess of $30,000 would result in an undue hardship, and discharged the amount beyond that threshold. The lender appealed, and the Ninth Circuit vacated and remanded the bankruptcy court's decision, reassessing the lower court's application of the *Brunner* standard. The appellate court found that the bankruptcy court did not adequately consider the first *Brunner* factor as to whether the debtor could have reduced his expenditures or increased his income through part-time work to meet a greater obligation.

The appellate court likewise found that the lower court's analysis of the second two prongs was incomplete. With particular regard to the third *Brunner* factor, a showing of good faith, the Ninth Circuit found that the bankruptcy court was "too charitable"[59] in finding good faith. Specifically, the appellate court noted that the debtor and his wife had taken no steps to increase their income or reduce their expenditures, especially by eliminating luxury items.

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[58] 368 Fed. Appx. 819 (9th Cir. 2010).

[59] *Id.* at 821.

Timing can also affect a showing of undue hardship. A former student who had previously obtained a Chapter 7 bankruptcy discharge sought to dismiss her $145,000 student loan obligations three years later.[60] The plaintiff received a Chapter 7 discharge of her obligations, not including her student loans, at a time when her income was modest but improving. However, she was then injured in an automobile accident and sought to reopen her case to pursue the discharge of her student loan obligations. A federal bankruptcy court concluded that the events leading to a successful demonstration of undue hardship must arise prior to the entry of the discharge. The court reasoned that because the automobile accident bore no causal relationship to the plaintiff's initial bankruptcy filing, it could not be relied upon later to satisfy the undue hardship standard for discharge of student loans. The court did note that subsequent events can have bearing on a plaintiff's ability to prove undue hardship, but only through seeking another discharge.

2. Undue Hardship Established

Truly dire financial circumstances can aid in establishing a showing of undue hardship on the part of a debtor, especially when coupled with a good faith effort to repay the obligation. A forty-nine year old debtor who filed for relief under Chapter 7 of the Bankruptcy Code sought to have his $80,000 in student loans discharged through the undue hardship exception.[61] The debtor, who was homeless, unemployed, and penniless

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[60] *Zygarewicz v. Educational Credit Management Corporation (In re Zygarewicz)*, 423 B.R. 909 [254 Ed. Law Rep. 221] (Bkrtcy.E.D.Cal. 2010).

[61] *Mabry v. U.S. Dept. of Educ. (In re Mabry)*, 398 B.R. 339 [240 Ed. Law Rep. 255] (Bkrtcy.E.D.Mo. 2008).

at the time of the trial successfully argued that excepting the student loans from his discharged debt would impose an undue hardship. The United States Bankruptcy Court for the Eastern Division of Missouri, noting that the case was difficult and arguments could be made to support the positions of all parties, concluded that the debtor had not abused the bankruptcy process and had established that his financial position was so precarious that failure to discharge the loans would place an undue burden on him.

In *Groves v. Citibank (In re Groves)*,[62] a debtor who filed for relief under Chapter 7 of the Bankruptcy Code sought to have $185,000 in student loans discharged, arguing that failure to do so would result in an undue hardship. The debtor accrued these student loans in the ultimate pursuit of a doctoral degree that she did not complete because of poor grades, and she contended that she suffered from depression as a result. The United States Bankruptcy Court for the Western Division of Missouri found that despite the fact that the debtor was depressed, she could work in the field in which she possessed a master's degree. However, the court reasoned that while she was capable of making some student loan payments, the amount of her monthly payment if the loans were not discharged would total approximately $850, which would result in an undue hardship. The court calculated that the debtor would be able to absorb a monthly payment of approximately $300 without imposing an undue hardship, and accordingly discharged approximately $148,000 of the student loans.

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[62] 398 B.R. 673 [240 Ed. Law Rep. 263] (Bkrtcy.W.D.Mo. 2008).

In *Coco v. New Jersey Higher Education Student Assistance Authority (In re Coco)*,[63] the Third Circuit considered only the good faith provision of the *Brunner* test to determine dischargeability of a student loan obligation. In this case, the debtor accumulated $25,000 in student loans in obtaining an associate's degree and a bachelor's degree in history between 1989 and 1992. After suffering a variety of serious illnesses that caused financial difficulty, she sought to discharge her student loans in 2005, at which time she owed over $70,000. A federal bankruptcy court denied the discharge, finding that she had made absolutely no showing of good faith that she had attempted to repay the loans. A federal district court affirmed on appeal. The Third Circuit disagreed, however, finding that the good faith provision recognizes that default may be caused by factors beyond the debtor's control. With regard to finding employment, maximizing income, or minimizing expenses, the appellate court found that the debtor had sought and held employment, although her medical conditions and her care for her elderly mother often made it difficult to do so. The court also noted that she had sought to minimize expenses, finding that her few discretionary dollars were spent on periodicals and pet food, and that she had been cooperative with the lender. Thus, because she struggled at or near the poverty line for nearly a decade before filing for bankruptcy, during which she sought employment and minimized expenses while facing serious medical challenges, the Third Circuit found that she had exhibited good faith sufficient to survive summary judgment.

3. Failure to Follow the Bankruptcy Rules, Suggestive of Espinosa

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[63] 335 Fed. Appx. 224 [250 Ed. Law Rep. 73] (3d Cir. 2009).

Cases such as the following one had been treated differently across the various federal circuits, leading ultimately to the Supreme Court's decision in *Espinosa*, which is analyzed in the following section. In these cases, debtors successfully discharged student loan obligations outside of the adversary proceeding the Bankruptcy Code requires. In some circumstances, if the lender had notice and did not respond in a timely fashion, courts have upheld the discharge. *Espinosa* is such as a case, as is *Needelman v. Pennsylvania Higher Educ. Assistance*,[64] in which an attorney who entered Chapter 13 bankruptcy sought to recover sums collected by student loan creditors on debt he had already discharged. The debtor entered Chapter 13 bankruptcy, crafted a plan to pay a portion of his debt, and successfully paid that portion over time. His creditors continued to ask for monthly payments, contending that his debt was not discharged because he had not proven undue hardship in an adversary hearing. The U.S. district court in California concluded, however, that because the plaintiff successfully adhered to the plan crafted under Chapter 13, of which the creditors had notice and did not contest, the plaintiff could state a claim for recovery of the amount collected by the creditors in excess of the plan.

IV. *UNITED STUDENT AID FUNDS v. ESPINOSA*

On March 31, 2010, the United States Supreme Court rendered a decision in *United Student Aid Funds v. Espinosa*,[65] a unanimous but narrow ruling in favor of a debtor who sought to discharge a student loan obligation through Chapter 13 bankruptcy,

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[64] 399 B.R. 695 [241 Ed. Law Rep. 203] (S.D.Cal. 2009).

[65] 130 S.Ct. 1367 (2010).

but did not follow the correct legal procedures to do so. As previously noted, under federal bankruptcy law, student loan debt is discharged through a determination of undue hardship ascertained through an adversary proceeding requested by the debtor. The Court granted certiorari because of a circuit split regarding whether a bankruptcy court's discharge of student loan debt, without a finding of undue hardship to the borrower through an adversary proceeding, violates bankruptcy law. The Supreme Court decision affirmed the Ninth Circuit's ruling,[66] overturned the decisions of five other federal circuit courts,[67] and was closely watched by members of the higher education community, scholars of bankruptcy law, lenders, and potential litigants who wish to discharge student loan obligations. The decision, authored by Justice Thomas, also engendered much media speculation prior to its announcement.[68]

Francisco Espinosa took out student loans in 1998 and 1999 in the amount of $13,250 to pursue a technical degree.[69] In 1992, Espinosa filed a Chapter 13 bankruptcy

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[66] 530 F.3d 895 [234 Ed. Law Rep. 28] (9th Cir. 2008).

[67] *In re Mersmann*, 505 F.3d 1033 (10th Cir. 2007)(en banc); *Whelton v. Educational Credit Management Corp.*, 432 F.3d 150 [204 Ed. Law Rep. 492] (2d Cir. 2005); *In re Ruehle*, 412 F.3d 649 [204 Ed. Law Rep. 492] (6th Cir. 2005); *In re Hanson*, 397 F.3d 482 [195 Ed. Law Rep. 93] (7th Cir. 2005); *In re Banks*, 299 F.3d 296 [169 Ed. Law Rep. 22] (4th Cir. 2002).

[68] *See, e.g.,* Asher Hawkins, *Bankruptcy: New Haven for Student Borrowers?*, FORBES MAG., October 20, 2009; Eric Kelderman, *Justices Question Legal and Practical Issues in Case Involving Student Debt in Bankruptcy*, CHRON. HIGHER EDUC., December 1, 2009; Eric Kelderman, *Supreme Court Considers Case About Excusing Student Debt Through Bankruptcy*, CHRON. HIGHER EDUC., November 29, 2009; Eric Kelderman, *Supreme Court Rules Unanimously to Dismiss Former Student's Debt*, CHRON. HIGHER EDUC., March 23, 2010; and Adam Liptak, *Bankruptcy Ruling in Student Loan Case*, N.Y. TIMES, Mar. 24, 2010, at A17.

[69] *Espinosa*, 130 S.Ct. 1367, 1373.

petition, which permits for debtors to reorganize their obligations and develop a plan to repay all or a portion of their debts over time.[70] As noted, such plans are effective upon confirmation by a bankruptcy court and result in the discharge of debts identified in the plan if the debtor completes the payments outlined in the plan. However, in order to discharge student loan debt, it must be determined to present an undue hardship to the debtor through a separate adversary proceeding.

In his plan, Espinosa listed his student loan debt as his only indebtedness and proposed to repay only the principal, discharging the interest once repaid.[71] The plan also noted the deadlines for filing an objection. The clerk of the bankruptcy court mailed notice and a copy of the plan to the lender, United Student Aid Funds (United).[72] United received this notice, but did not object to the proposed discharge of the interest, nor did it object to Espinosa's failure to initiate the adversary proceeding to determine the debt's dischargeability.[73]

The bankruptcy court confirmed the plan without holding an adversary proceeding or making a finding of undue hardship in May 1993.[74] United was provided notice that the claim would be repaid as listed in the plan and allowed 30 days to dispute the claim.[75] Four years later, Espinosa successfully repaid the principal as required by

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[70] *Id.*

[71] *Id.* at 1374.

[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

the plan, and the bankruptcy court subsequently discharged the interest on the student loan.[76]

However, in 2000, the U.S. Department of Education (DOE) sought to collect the unpaid interest on the loan, and in 2003 Espinosa filed a motion asking the bankruptcy court to enforce its 1997 discharge of the interest by directing the DOE and United to cease all efforts to collect the unpaid interest.[77] United cross-motioned, asking the court to void the 1993 order confirming Espinosa's plan.[78] In its motion, United argued that the provision of the plan authorizing the discharge of the debt was not consistent with the Bankruptcy Code, which requires a finding of undue hardship to discharge student loan debt, and with the Bankruptcy Rules, which require this finding to be made through an adversary proceeding. United also argued that its due process rights had been violated because Espinosa failed to serve it with the summons and complaint required by the Rules prior to an adversary proceeding.[79]

The bankruptcy court favored Espinosa, directing United and the DOE to cease collection efforts. On further review, however, a federal district court reversed in favor of United, finding that its due process rights had been violated. On appeal, the Ninth Circuit Court of Appeals reversed in favor of Espinosa, concluding that while the bankruptcy court committed a legal error that could have been appealed in confirming the

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[76] *Id.*

[77] *Id.*

[78] *Id.*

[79] *Id.* at 1374-1375.

plan, that error was not the basis for voiding the confirmation under the Bankruptcy Rules. Further, the appellate court held that although Espinosa failed to serve United with a summons and complaint to initiate the adversary proceeding, this was not a sufficient basis to void the plan because United received actual notice of the plan and failed to object. The Ninth Circuit's ruling disagreed with decisions in five other federal circuits.[80]

The Supreme Court affirmed the Ninth Circuit's ruling in favor of Espinosa. The Court first examined whether the erroneous discharge of Espinosa's student loan debt without a finding of undue hardship in an adversary proceeding was sufficient to render the plan void under a Bankruptcy Rule that applies only where the judgment is premised on a jurisdictional error or on a due process violation depriving a party of notice or opportunity to be heard.[81] While United did not make a jurisdictional argument, it did contend that its due process rights were violated because Espinosa failed to serve a summons and complaint initiating the adversary proceeding necessary to reach a determination of undue hardship.[82] The Court disagreed, noting that United could have timely objected and, further, United received actual notice of the filing and the structure of Espinosa's plan, which more than satisfied due process.[83]

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[80] The Ninth Circuit's decision conflicted with other decisions from the 2nd, 4th, 6th, 7th, and 10th Circuits. *See supra* text accompanying notes 66-67.

[81] *Espinosa* at 1376.

[82] *Id.* at 1378.

[83] *Id.*

United next argued that the bankruptcy court lacked the statutory authority to confirm the plan absent a finding of undue hardship.[84] The Court again disagreed, concluding that the failure to make a determination of undue hardship, while an error, did not create a jurisdictional or due process violation sufficient to void the decision under the Bankruptcy Rules.[85]

The Court reasoned that the order remained binding because United had notice of the error and failed to object or timely appeal.[86] United argued that it was not obligated to object to the plan until served with a summons and complaint, but the Court dismissed that argument, again noting that United had actual notice of the filing of the plan, its contents, and the bankruptcy court's confirmation of the plan, which forfeited any argument concerning the validity of service because it failed to timely object.[87] The Court specifically admonished United on this point, noting that the Bankruptcy Rule related to voiding a judgment "does not provide a license for litigants to sleep on their rights."[88]

In ruling in favor of Espinosa, the Ninth Circuit looked beyond the question of whether his plan was void under Bankruptcy Rules, reviewed other bankruptcy confirmations, and concluded that bankruptcy courts *must* confirm a plan proposing the discharge of student loan obligations without a determination of undue hardship through

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[84] *Id.*

[85] *Id.* at 1379.

[86] *Id.* at 1380.

[87] *Id.*

[88] *Id.* at 1380.

an adversary proceeding unless the creditor raises a timely objection.[89] The Supreme Court disagreed, concluding that the Code is clear that bankruptcy courts are obligated to conform the plan to the stated requirements directing a determination of undue hardship even if a creditor fails to object or appear in the adversary proceeding.[90]

However, in interesting language that may provide an alternative for some debtors, the Court noted that if the creditor and debtor agree that repayment of an obligation would create an undue hardship, there is no reason that the additional required procedures should impose more costs on the parties or delay the confirmation of the plan:

> We are mindful that conserving assets is an important concern in a bankruptcy proceeding. We thus assume that, in some cases, a debtor and creditor may agree that payment of a student loan debt will cause the debtor an undue hardship sufficient to justify discharge. In such a case, there is no reason that compliance with the undue hardship requirement should impose significant costs on the parties or materially delay confirmation of the plan. Neither the Code nor the Rules prevent the parties from stipulating to the underlying facts of undue hardship, and neither prevents the creditor from waiving service of a summons and complaint. But, to comply with Section 523(a)(8)'s directive, the bankruptcy court must make an independent determination of undue hardship before a plan is confirmed, even if the creditor fails to object or appear in the adversary proceeding.[91]

V. CONCLUSION AND FUTURE IMPLICATIONS

The undue hardship standard articulated by Congress in the Bankruptcy Code, but without specific definition of the term, has engendered speculation, litigation, and

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[89] *Id.*

[90] *Id.* at 1381.

[91] *Id.* at 1381. The Court also acknowledged the potential for bad-faith litigation in the hope of discharging student loan obligations as a result of the ruling, but noted the strident penalties attorneys may face, and looked to Congress to provide for additional penalties if such bad-faith litigation follows the decision.

legislation over time, and has left individual debtors seeking to discharge student loans at the mercy of the vagaries of a judge's discretion. Calls have been made for a uniform definition of the standard, but have been unheeded, resulting in inconsistent decisions among the courts and federal appellate circuits.

Changes in the Code regarding private student loans are now emerging as a salient issue, especially as American society embraces for-profit education as never before. The public policy issues surrounding discharge of private student loans have long been debated, and may soon shift again away from the favor of the lending industry and toward the debtor, which should be followed closely by policy analysts and institutions of higher learning. If private student loans are decoupled from the undue hardship standard, discharging them in a bankruptcy proceeding will become much less burdensome. While this may favor the honest and unfortunate debtor, it could also provide a simpler outlet for less scrupulous debtors to seek dismissal of these financial obligations to the detriment of lenders and educational institutions.

The Supreme Court's opinion in *Espinosa* is also poised to influence discharge of student loan obligations, an issue of direct interest to financial aid administrators and counsel who would be involved in procedural matters related to student-debtors. The decision was followed closely by the higher education community, lenders, and debtors, and was focused primarily on narrow procedural questions, doing little to address the lack of a cohesive standard surrounding the finding of undue hardship necessary to discharge student loan obligations in bankruptcy. This standard is nebulous and difficult to meet, and the Court left analysis of the undue hardship standard itself untouched.

However, the decision in *Espinosa* was rendered to resolve a question that split federal appellate circuits, and upheld the discharge of student loans without an adversary proceeding, but finding it legal error nonetheless. Ultimately, providing notice of the bankruptcy plan to the creditor was sufficient to uphold discharge of the student loan obligation because the creditor remained silent. Administrators and university counsel should take note and review policies to ensure that prompt responses are provided to any proposed bankruptcy plans or filings in which their institutions are involved. Institutions can also proactively respond to the increasing trend in student loan default rates by taking steps to provide more education to students, specifically about the importance of rational and realistic borrowing, the financial consequences that will ensue if loans are not repaid, and the difficulty in discharging student loans in bankruptcy.

Espinosa may also ease the burden for some debtors by suggesting that if debtor and creditor agree that repayment would create an undue hardship, then the additional legal procedures required to reach that conclusion could be omitted, saving cost and time. This suggestion raises the question, however: What is the undue hardship standard to be agreed upon by debtors and creditors, if one cannot be agreed upon by Congress and the courts? Regardless, the decision may make discharge of student loan obligations a more realistic and less expensive option for some student-debtors. Although the Supreme Court's decision noted the necessity of an adversary proceeding, unless perhaps debtor and creditor agree that repayment would constitute an undue hardship, ultimately an amendment of the Bankruptcy Code would clarify debtors' and creditors' rights in these circumstances, providing guidance in an otherwise subjective process that often disfavors the honest but unfortunate debtor.