Reducing the Life Sentence of Student Loans

Written by:
Madeleine Patton
Georgia State University College of Law
Atlanta
patton.madeleine@gmail.com

Brandon Howard
Georgia State University College of Law
Atlanta
matthewbhoward@gmail.com

About the Authors

Madeleine Patton and Brandon Howard are third-year law students at Georgia State University College of Law in Atlanta.

A young hopeful student, discouraged by the economy and dismal job prospects, sees higher education, including graduate school, as an investment in the future; a way to guarantee employment or a higher salary. Unfortunately, that guarantee now seems to fall between unadulterated hope and delusions of grandeur. A recent article quoted a young attorney who admitted that law school was the "worst investment of her life."[1]

Madeleine Patton

Student loan defaults have increased 1.8 percent from last year,[2] and in every other category of debt, Americans are cutting back.[3] Yet the Federal Reserve recently reported that Americans now owe more in educational loans than they do in credit card debt.[4] In a down economy, students are receiving educational loans with increasing frequency. The rise in student loans seems to mimic that of the housing bubble, but unlike the albatross of an underwater mortgage or unmanageable credit card debt, student loans are nearly impossible to discharge in bankruptcy. There are, however, practical remedies that can help to relieve some of the burden of student debts without wreaking the economic havoc that an immediate full discharge of education loans might cause.

A Short History of Nearly Everything

Congress is delegated with the ability to regulate bankruptcies under the Constitution, but it did not address the treatment of student loans in bankruptcy until the 1978 Bankruptcy Code reform.[5]

An increasing reliance on the government-created student-loan programs prompted the creation of § 523(a)(8)(A), which prohibited the discharge of federal student loans under chapter 7, except for loans that became due five years before the filing of a bankruptcy petition.[6] Congress specified that those loans could be discharged in situations where the loans "impose an under hardship on the debtor." Twelve years later, Congress updated the Code, lengthening the five-year exception period to seven years, and applied the general nondischargeability of student loans to chapter 13 debtors. Convinced that abusive filings could become rampant, Congress amended the Code in 1998 so that debtors had no opportunity to discharge *any* federal student loans outside of the "undue-hardship" provision of § 523(a)(8)(B).[7] In 2005, under pressure from the public, lenders and lobbyists, Congress expanded the umbrella of loans in § 523(a)(8) to include private loans, ushering in an era of true nondischargeability for educational loans and insurmountable hardships for students.

Even with a super-sized § 523(a)(8), Congress left the ostensible availability of the undue-hardship exception intact. The term "undue hardship" lacks any definition in the Code, so courts are left to mete out the requirements and effects of the hardship discharge.[8] Not surprisingly, courts have come to a variety of inconsistent and unpredictable conclusions as to how § 523(a)(8) should be administered.

Under the *Johnson* test, the court considers "the debtor's past resources and future probable resources...good faith...[and] the debtor's motives in filing for bankruptcy" in determining if any discharge should be granted.[9] Eight years later, the same court created the less-complicated, more objective *Bryant* poverty test.[10] Debtors whose net income after taxes fell below the federal poverty lines or those in "unique" and "extraordinary" circumstances were entitled to a discharge. The more frequently applied totality-of-the-circumstances test examines all relevant factors in each case, such as "financial resources [and] necessary expenses."[11] Last, the majority *Brunner*[12] test evaluates whether "the debtor cannot...maintain a 'minimal' standard of living for himself...or his dependents if forced to repay the loans... the debtor's state of affairs is likely to persist for such a significant portion of the repayment period...[and] the debtor has made good faith efforts to repay the student loans."[13]

Brandon Howard

Student Gallery

Critics argue that the application of "unworkable" undue-hardship tests "ha[ve] resulted in more harm than good."[14] Different jurisdictions produce widely varied decisions regarding what constitutes hardship, how long it must persist and what percentage of loans qualify for discharge,[15] and debtors wishing to discharge student loans cannot predict whether an evidence-laden trial is worth their time and money.

Bankruptcy as Avenue for Relief

Why Bankruptcy Is Not Currently an Available Remedy

The cornerstone of the bankruptcy system is that debtors are entitled to a "fresh start." Yet under the current system, the best-case scenario for a debtor struggling with student loans is a "stale" start, given

1 William D. Henderson and Rachel M. Zahorsky, "The Law School Bubble: How Long Will It Last if Law Grads Can't Pay Bills?," *ABA Journal* (Jan. 1, 2012).

2 Tamar Lewin, "Student Loan Default Rates Rise Sharply in Past Year," *New York Times* (Sept. 12, 2011) (citing that in past year, college graduates' default rates rose 3.4 percent for for-profit universities, 1.2 percent for nonprofit universities and 0.6 percent for private universities).

3 Michelle Singletary, "Student Debt Hint: Avoid It," *Washington Post* (Nov. 29, 2011).

4 *Id.*

5 Katheryn E. Hancock, "A Certainty of Hopelessness: Debt, Depression and the Discharge of Student Loans under the Bankruptcy Code," 33 *Law & Psychol. Rev.* 151, 151 (2009).

6 *Id.* at 152.

7 B.J. Huey, "Undue Hardship or Undue Burden: Has the Time Finally Arrived for Congress to Discharge Section 523(a)(8) of the Bankruptcy Code?," 34 *Tex. Tech L. Rev.* 89, 97-8 (2002-03).

8 *Id.* at 101.

9 *Id.* at 102 (citing *Pennsylvania Higher Education Assistance Agency v. Johnson*, 5 Bankr. Ct. Dec. 532 (Bankr. E.D. Pa. 1979)).

10 *Id.* at 104 (citing *Bryant v. Pennsylvania Higher Education Assistance Agency*, 72 B.R. 913, 914 (Bankr. E.D. Pa. 1987)).

11 *Id.* (citing *Andrews v. South Dakota Student Loan Assistance Corp.*, 636 F.2d 233 (Bankr. S.D. 1980)).

12 *Brunner v. New York State Higher Educ. Serv. Corp. (In re Brunner)*, 831 F.2d 395 (2d Cir. 1985).

13 *Id.* at 109-10.

14 *Id.* at 112.

15 Rafael Pardo and Michelle Lacey, "The Real Student-Loan Scandal: Undue Hardship Discharge Litigation," 83 *Am. Bankr. L. J.* 179, 229 (2009) (finding that identity of debtor's attorney and judge were statistically determinant factors in whether debtor's student loan was discharged under undue-hardship standard).

the Code's implicit assumption of fraud and opportunism. The theory is that if bankruptcy were available, students would borrow significant funds, then promptly discharge all debts upon graduation—thus "picking [his or] her debt relief...when [his or] her realizable assets and present income are at their lowest and...debt and future income are at their highest."[16]

The issue lies in the fact that student loans are wholly unsecured; the lender has neither liens nor recourse. Students cannot return the knowledge they gained, and critics argue that "[s]tudents will be able to realize the benefit of education and translate that benefit into [future] financial payoff," long after they have shirked their responsibilities to the lender and to society.[17] Such a precedent, opponents contend, would involve the collapse of the accessibility of higher education to those who require the assistance of student loans, an argument that allows bankruptcy to become "an indirect lever for education policy."[18] Prevailing policy succumbs to the belief that "making bankruptcy harsher for the debtor...makes borrowing more affordable for that debtor in particular and all borrowers generally."[19]

While theories of abuse are prevalent, irrational abuse theories are not realistic: Bankruptcy abuse is not the norm, and there are strong societal stigmas and future financial hardships associated with filing.[20] The Bankruptcy Code has mechanisms in place to catch frivolous filers, such as the trustee system, the chapter 7 means test and provisions designed to catch fraudsters.[21] The National Bankruptcy Review Commission noted that when federal student loans were dischargeable under chapter 7, "a fraction of 1% of all matured student loans were discharged," and under chapter 13, "less than 7/10 of 1% of total debt...was for educational loans."[22] Nonetheless, BAPCPA did not acknowledge the history of low student loan bankruptcy rates. The fact that "[w]hen student loans *were* discharged in bankruptcy...debtors [generally] also had other significant indebtedness," suggested that true financial need permeates the market of student loan holders, since student loan default rates continue to rise—even though bankruptcy relief is unavailable.[23]

Returning Relief as Clear, Viable Option

Bankruptcy has always been an option for student debtors, but the current undue-hardship standard is such an inflexible rule that a debtor must show an almost impossibility of repayment to qualify, restricting the viability of bankruptcy as a relief mechanism.[24] Further, courts are split over whether they maintain an equitable power of the bankruptcy court to fashion remedies despite a determination of undue hardship. Congress should act to clarify or revise the Code to ensure equitable options for student debtors in bankruptcy proceedings.[25]

An overhaul to the treatment of student loans in bankruptcy must achieve three goals: (1) provide more equitable treatment of student borrowers, (2) continue to encourage lending to student borrowers and (3) prevent gaming of the bankruptcy system. First, Congress should explicitly provide that bankruptcy courts may use their § 105(a) equity powers to fashion remedies with respect to student borrowers, which would resolve the conflict among jurisdictions and would allow courts to tailor the bankruptcy proceedings of individual cases rather than a group.[26] Such equitable remedies could include partial discharge or an implementation of a temporary income-based repayment plan for private loans. Various congressional bills currently in circulation provide options such as debt "swaps" of private for public debts, or an outright full discharge.[27] In order to prevent the inequity of current proceedings, Congress must also explicitly state that the undue-hardship standard need not be met to invoke equity; however, the level of hardship must increase depending on the level of equitable remedy sought. Ultimately, full discharge (at least for a time) should be subject to the current undue-hardship standard.

By embracing their equitable powers, courts would also promote the second and third goals. Equity does not reward those with "unclean hands."[28] Thus, bankruptcy courts would be vigilant and scrutinizing when confronted with a request for an equitable remedy from a student borrower. Lenders could allege debtor wrongdoing and have the court consider whether equity is appropriate. Further, the lender is not precluded from arguing that a specific remedy is unfair or unnecessary. Thus, lenders may challenge borrowers in bankruptcy and win, but the lender will not be guaranteed a win. With this system in place, lenders should still feel secure in lending to student borrowers because full discharge is not guaranteed and equitable relief can be challenged.

Last, to prevent gamesmanship and abuse, Congress could limit the availability of a full discharge. In order to attain a complete discharge within a set number of years after graduation, a debtor would have to demonstrate the undue-hardship standard, which would protect the lender from a complete loss for a fixed time, thus keeping an incentive for the lender to lend, and would allow the graduate time to seek other remedies in repaying his or her obligation. However, after a period of seven to 10 years following graduation, it is increasingly unlikely that any request for bankruptcy hinges on student loans alone, but instead on the entirety of accumulated debt. Thus, once that time period has passed, one can eliminate the stringent undue-hardship standard and simply permit full discharge within the court's equitable powers as a part of a complete bankruptcy proceeding.[29]

Conclusion

There are plausible options to loosen the shackles on graduates haunted by their student debts. While initially unpalatable to lenders, affording debtors equitable options to manage their student loans is the only way to avoid the crumbling of our higher education system and an economy that depends on those graduates. We need not jump to harsh conclusions and full discharge, but should realize that the Bankruptcy Code stands as a flexible document that can be altered to suit the needs of student citizens who currently face one of the harshest economic climates in decades, with no "fresh start" in sight. ■

16 *Id.*
17 John A.E. Pottow, "The Nondischargeability of Student Loans in Personal Bankruptcy Proceedings: The Search for a Theory," 44 *Can. Bus. L. J.* 245, 254 (2007).
18 *Id.*
19 *Id.*
20 Sara Murray, "Bankruptcy Comes with Social Stigma," *Wall Street Journal* (Nov. 25, 2010).
21 11 U.S.C. § 707(b)(2)(A). See 11 U.S.C. § 523(a)(2).
22 Nat'l Bankr. Rev. Comm., *Bankruptcy: The Next 20 Years*, 210 (Oct. 20, 1997), http://govinfo.library.unt.edu/nbrc/reportcont.html. *See also* Robert Salvin, "Student Loans, Bankruptcy and the Fresh-Start Policy: Must Debtors Be Impoverished to Discharge Educational Loans?," 71 *Tul. L. Rev.* 139, 145-46 (1996) ("Although student loan bankruptcies were actually small in number and dollar amount...the media tended to portray the abuse as a potentially widespread phenomenon.").
23 Robert M. Lawless and Elizabeth Warren, "Shrinking the Safety Net: The 2005 Changes in U.S. Bankruptcy Law," at 2, U. Illinois Law and Economics Working Paper Series, Research Paper No. LE06-031 (2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=949629, Nat'l Bankr. Rev. Comm., *supra*, n. 22, at 210; *supra*, n. 2.
24 Andrew MacArthur, "Pay to Play: The Poor's Problems in the BAPCPA," 25 *Emory Bankr. Dev. J.* 407, 468-69 (2009).
25 *Hemar Ins. Corp. of Am. v. Cox (In re Cox)*, 338 F.3d 1238, 1242 (11th Cir. 2003) (internal citation omitted); *See generally* Brendan Hennessy, "The Partial Discharge of Student Loans: Breaking Apart the All or Nothing Interpretation of 11 U.S.C. 523(a)(8)," 77 *Temp. L. Rev.* 71 (2004); Frank Bayuk, "The Superiority of Partial Discharge for Student Loans under 11 U.S.C. § 523(A)(8): Ensuring a Meaningful Existence for the Undue-Hardship Exception," 31 *Fla. St. U. L. Rev.* 1091 (2004).
26 *Tennessee Student Assistance Corp. v. Hornsby (In re Hornsby)*, 144 F.3d 433, 438-40 (6th Cir. 1998), 144 F.3d at 440, 438-40 (6th Cir. 1998) (stating that courts could use its equity power by "partially discharging loans, whether by discharging an arbitrary amount of the principal, interest accrued or attorney's fees; by instituting a repayment schedule; [or] by deferring the debtor's repayment of the student loans").
27 *See generally* Student Loan Bill Tracker, www.studentloanbilltracker.com.
28 *See Precision Instrument Mfg. Co. v. Autom. Maint. Mach. Co.*, 324 U.S. 806, 814-15 (1945) ("[Equity requires] that [the invoking party] shall have acted fairly and without fraud or deceit as to the controversy in issue.").
29 Ron Lieber, "Student Debt and a Push for Fairness," *New York Times* (June 4, 2010) (citing that for-profit lender Sallie Mae is in support of dischargeable student loans, if there is waiting period between graduation and eligibility).

Copyright 2012 American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.