Student Loans and Bankruptcy

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Overview 1

- Student loans represent a large and growing share of household and nationwide consumer debt. In just the last ten years, aggregate student loan balances have quadrupled due to growth in both college enrollment and increases in tuition.

Overview 2

- Outstanding student loan balances now exceed outstanding credit card or auto loan balances.

- Americans today owe more than $1 trillion in student loans either held or guaranteed by the federal government and about $165 billion in private student loans.

Overview 3

- Student debt has serious consequences for borrowers struggling to make ends meet. A recent study found that 40% of students delayed a major purchase, such as a home or car, because of student loan debt, and more than a quarter moved in with parents or family members to save money. A similar proportion dropped out of school or put off continuing their education.

- Source: Charley Stone, Carl Van Horn & Cliff Zukin, Chasing the American Dream: Recent College Graduates and the Great Recession, RUTGERS SCH. PLANNING & PUB. POL'Y at 13 (May 2012), available at http://media.philly.com/documents/20120510_Chasing_American_Dream.pdf.

Overview 4

- Student debts for professional schools like medicine and law as well as graduate degrees reach in the $100,000 to $200,000 range, some more.

Overview 5

- Of the major types of household debt, the rate of delinquent payments is highest among student loans, at 11.5 percent.

- Source: Danielle Douglas, Household Debt Grows, but Americans Seem More Cautious, WASH. POST (February 19, 2014), at A8.

Two Basic Types of Student Loans

- First, “federal” student loans, which are issued pursuant to a federal program and governed by a substantial body of federal law; and
- Second, “private” student loans, which are issued by states, financial institutions, and schools, and are, for most purposes, governed only by generally applicable laws regulating financial credit products.

Federal Student Loans

- Federal student loans are issued under three programs: the Federal Direct Loan Program, the Federal Perkins Loan Program, and Federal Family Education Loan (FFEL) Program.
- Direct and FFEL loans can be further classified into two types of loans: Stafford and PLUS loans.

Private Student Loans

- Private student loans are not issued pursuant to a federal program. These loans may come from a variety of sources, including financial institutions, nonprofit organizations, states, and even schools themselves.
- Private student loans typically carry higher interest rates than federal loans and may also subject buyers (students or parents) to pre-payment penalties.

Private Student Loans

- For the most part, the law treats these loans as any other credit product, with one key exception: like federal student loans, many private student loans are exempted from discharge from bankruptcy.

Discharging Legal Liability for Student Loans

- There are two ways borrowers may potentially discharge their student loan debt: statutory discharge under certain provisions of the Higher Education Act, and discharge in bankruptcy.
- Neither is particular easy to obtain.

Discharge 2

- Under 20 U.S.C. § 1087(c), student loans received after January 1, 1986, may qualify for a school-related discharge on one of three grounds: school closure, false certification, and unpaid refund. The link between these three grounds for discharge is misconduct or some failure to perform on the part of the school itself.

Exception for Perkins Loans

- 34 C.F.R. §§ 685.214(e), 685.215(c)(6)(ii), 685.216(c)(1)(iii)(B), 682.402(d)(5), 682.402(e)(5), 682.402(l)(4)(iii)(B), 674.33(g)(7). Administrative unpaid refund and false certification discharges are not available for Perkins loans, but borrowers should be able to raise these matters as defenses or counterclaims in litigation.

Perkins Exception 2

- A borrower may be ineligible for discharge if she obtained the loan by fraudulent means.

- 34 C.F.R. § 674.33(g)(5) (Perkins). The regulations for Direct and FFEL loans do not contain such a provision.

- When a school, without authorization, signs a student's name to a loan application or promissory note, the student is entitled to discharge of the entire amount of the unauthorized loan. 34 C.F.R. §§ 685.215(a)(1)(ii), (b)(1), 682.402(e)(1)(i)(B), (e)(2)(i).

- Additionally, when a school endorses a student loan check in the borrower's name or authorizes on the borrower's behalf an electronic transfer of student loan funds, the student may be entitled to discharge the amount of the check or transfer. 34 C.F.R. §§ 685.215(a)(1)(iii), (b)(2), 682.402(e)(1)(i)(C), (e)(2)(v).

Discharge for Death

- The Secretary, guaranty agency, or educational institution should discharge a loan upon receiving an original or certified copy of a death certificate of either the borrower or in the case of a parent PLUS loan, the student.
- 20 U.S.C. §§ 1087(a)(1) (FFEL), 1087dd(c)(1)(F)(i) (Perkins); 34 C.F.R. §§ 685.212(a) (Direct), 682.402(b) (FFEL), 674.61(a) (Perkins). Loans may be discharged based on other reliable evidence of death in extraordinary circumstances. 34 C.F.R. §§ 685.212(a)(2) (Direct), 682.402(b) (FFEL), 674.61(a) (Perkins).

Or Disability

- Student loans may also be discharged if the *borrower* becomes totally and permanently disabled, as defined by the Secretary.

- 20 U.S.C. §§ 1087(a)(1) (FFEL), 1087dd(c)(1)(F)(ii) (Perkins); 34 C.F.R. §§ 685.213(b) (Direct), 682.402(c) (FFEL), 674.61(b) (Perkins). “Totally and permanently disabled” is defined at 34 C.F.R. § 682.200.

Disability 2

- A borrower seeking a disability discharge must submit an application to the lender, for a FFEL loan, or to the Secretary, for a Direct or Perkins loan. The application must include a certification by a physician that the borrower is totally and permanently disabled and must be submitted within 90 days of the physician's certification.

- In lieu of such a certification, Direct and Perkins borrowers may submit a notice of award of Social Security disability benefits from the SSA indicating that the borrower's next scheduled disability review will be within five to seven years.

Disability 3

- Once a borrower has notified the Secretary or the loan holder that she intends to seek a disability discharge, collection activity must be suspended for up to 120 days pending receipt of her application. After the borrower has submitted an application, collection activities must be suspended until the Secretary or loan holder reaches its decision.
- 34 C.F.R. §§ 685.213(b); 674.61(b)(2); 682.402(c)(7).

Disability 4

- If the Secretary determines that the borrower is permanently and totally disabled, the Secretary administratively discharges the loan; otherwise, the loan is due and payable to the Secretary under the terms of the promissory note.

- 34 C.F.R. §§ 685.213(b)(4)(iii)–(iv), 682.402(c)(3), 674.61(b)(3)(v)–(vi). A Perkins loan that is discharged must be assigned to the Secretary. 34 C.F.R. § 674.61(b)(3)(iv).

Disability 5

- If *the borrower's* application is deemed insufficient to prove disability, the Secretary may require submission of additional evidence or arrange for additional review of *the borrower's* condition by an independent physician at the government's expense.

- 34 C.F.R. §§ 685.213(b)(4)(ii), 682.402(c)(3)(ii), 674.61(b)(3)(ii).

Discharge in Bankruptcy

- "The principal purpose of the Bankruptcy Code is to grant a 'fresh start' to the 'honest but unfortunate debtor.'" To accomplish this purpose, the Code allows a debtor to discharge most unpaid debts, if the conditions for discharge are met.

- Marrama v. Citizens Bank of Massachusetts, 549 U.S. 365, 367 (2007).

Bankruptcy 2

- Some debts, however, may not be automatically discharged. Bankruptcy Code Section 523 (11 U.S.C. §523) lists the exceptions to the general rule.
- To attempt to discharge student loans within a bankruptcy, the debtor must initiate an Adversary Proceeding within his underlying bankruptcy case.

Bankruptcy 3

- Prior to enactment of the Bankruptcy Code in 1978, there was no special treatment or provision for student loans.
- Prior to October 7, 1998, the bankruptcy discharge of student loans was available to borrowers/debtors whose student loan obligations first came due more than seven years prior to the filing of a bankruptcy.

Bankruptcy 4 (BAPCPA)

- The Bankruptcy Abuse Prevention, Consumer Protection Act (BAPCPA) (Pub. L. No. 109-8, §220), effective October 17, 2005, included significant revisions to the student loan dischargeability standards found in 11 U.S.C. § 523(a)(8).

Bankruptcy 5

- The student loan exception provides that, "[u]nless excepting such debt from discharge

  . . . would impose an undue hardship on the debtor and the debtor's dependents," discharge is not available for:

Bankruptcy 6 (11 U.S.C. § 523(a)(8))

- “(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 was an individual.”

Bankruptcy 7 – What Changed in 2005?

- Adding the term “educational benefit” to the existing definitions of “student loan”.
- This made many private loans harder to discharge and brought them in line with treatment of federal student loans.

Bankruptcy 8 – 2005 Changes

- The 2005 changes to bankruptcy law also added the term “qualified educational loan”, as defined in section 221 of the Internal Revenue Code. 26 U.S.C. § 221(d).

Bankruptcy 9

- The Internal Revenue Code defines educational loans as any indebtedness incurred by the taxpayer *solely* to pay qualified higher education expenses.
- A "mixed-use" private loan, a loan not solely incurred for qualified educational expenses, is potentially eligible for discharge in bankruptcy. 26 C.F.R. § 1.221-1(e)(4) ex. 6 (stating that a private loan that is, in part, for residential improvements and, in part, for educational expenses does not qualify as an education loan).

Bankruptcy 10

- Note that the expenses must be incurred o/b/o the taxpayer, his/her spouse, or any dependent of the taxpayer, AND, must be paid or incurred within a reasonable period of time before or after the indebtedness is incurred and attributable to education furnished while the recipient was an eligible student.

Bankruptcy 11

- In short, if interest payments on the loan qualify for a tax deduction, the loan cannot be discharged in bankruptcy, absent a finding of “undue hardship”.

Bankruptcy 12 – Undue Hardship

- Whichever paragraph of section 523(a)(8) exempts a student loan from discharge, the debtor may still be entitled to discharge the loan if repayment would “impose an undue hardship on the debtor and the debtor’s dependents.”

Bankruptcy 13 – The Brunner Test

- Nine federal judicial circuits, apply the narrow three-prong test established in Brunner v. New York State Higher Education Services Corporation. 831 F.2d 395 (2d Cir. 1987).

- Illinois uses this case law criteria, Goulet v. Educ. Credit Mgmt. Corp., 284 F.3d 773 (7th Cir. 2003); so does Kansas, Educ. Credit Mgmt. Corp. v. Polleys, 356 F.3d 1302 (10th Cir. 2004);

Bankruptcy 14 – Brunner 2

- To satisfy the Brunner test, the debtor must "show that (1) he cannot maintain a minimal standard of living and repay the loans, (2) additional circumstances demonstrate that she will not be able to repay the loans for a substantial part of the repayment period, and (3) he attempted to repay the loans in good faith." The debtor must establish all three prongs by a preponderance of the evidence.

Bankruptcy 15 – Missouri is different

- The Eighth Circuit Court of Appeals created it's own test/standard in In re Long, 332 F.3d 549 (8th Cir. 2003).
- Long created and applied a "totality of the circumstances" test in determining whether student loan debt should be discharged based on undue hardship.

Bankruptcy 16 – Long
Totality of the Circumstances

- The debtor bears the burden of proving "undue hardship", by preponderance of evidence. ECMC v. Jesperson, 571 F.3d 775, 779 (8th Cir. 2009).

Bankruptcy 17 – Long 2

- In evaluating the totality-of-the-circumstances, bankruptcy courts should consider: (1) the debtor's past, present, *and reasonably reliable future* financial resources; (2) a calculation of the debtor's and his dependent's reasonable necessary living expenses; and (3) any other relevant facts and circumstances surrounding each particular bankruptcy case. Long, at 554.

Bankruptcy 18 – Long 3

- The totality-of-the-circumstances test is very broad. Courts in the Eighth Circuit have looked to a number of facts and circumstances to assist them in making this determination.
- Such factors include: (1) total present and future incapacity to pay debts for reasons not within the control of the debtor; (2) whether the debtor has made a good faith effort to negotiate a deferment or forbearance of payment; (3) whether the hardship will be long-term; (4) whether the debtor has made payments on the student loan; (5) whether there is permanent or long-term disability of the debtor; (6) the ability of the debtor to obtain gainful employment in the area of the study; (7) whether the debtor has made a good faith effort to maximize income and minimize expenses; (8) whether the dominant purpose of the bankruptcy petition was to discharge the student loan; and (9) the ratio of student loan debt to total indebtedness.
- McLaughlin v. U.S. Funds, 359 B.R. 746, 750 (Bankr. W.D. Mo. 2007)(Dow, J.).

Bankruptcy 19 – Long 4

- Simply put, if the debtor's *reasonable future financial resources* will sufficiently cover payment of the student loan debt-while still allowing for a minimal standard of living-then the debt should not be discharged. Certainly, this determination will require a special consideration of the debtor's present employment and financial situation-including assets, expenses, and earnings-along with the prospect of future changes-positive or adverse-in the debtor's financial position. Long, at 554-555.

Bankruptcy 20 – H.E.A.L. Loans

- From FY 1978 through 1998 the Federal Health Education Assistance Loan (HEAL) Program insured loans made by participating lenders to eligible graduate students in schools of medicine, osteopathy, dentistry, veterinary medicine, optometry, podiatry, public health, pharmacy, chiropractic, or in programs in health administration, and clinical psychology.
- HEAL refinancing occurred from FY 1994 through fiscal year 2004.

Bankruptcy 21 – H.E.A.L. 2

- New HEAL loans to student borrowers were discontinued as of September 30, 1998.

- Bankruptcy discharge of HEAL loans was/is only available by proving “unconscionability” … an even higher burden than “undue hardship”.

Bankruptcy 22

- That's all well and good….but what about ICRP/IBR?

Bankruptcy 23- Administrative Forgiveness/Discharge

See: U.S. Dep't of Educ., Income-Based Plan, Fed Student Aid, available at http://studentaid.ed.gov/repay-loans/understand/plans/income-based (setting forth advantages of the Income-Based Repayment Plan (IBR), including the twenty-five year forgiveness advantage whereby one may be forgiven of their remaining loan balance after twenty-five years of qualifying repayment).

Bankruptcy 24 - ICRP

- A direct loan borrower may use an Income Contingent Repayment Plan (ICRP) plan. ICRP plan payments are capped at 20% of the difference between the borrower's adjusted gross income and the relevant federal poverty guideline. 34 C.F.R. § 685.209(b)(1)(ii)(A)–(B).

Bankruptcy 25 - IBR

- Except for parent PLUS loans and consolidation loans taken out in part to repay a parent PLUS loan, all Direct and FFEL loans that are not in default are eligible for IBR. A borrower must have "partial financial hardship" to enter IBR; a borrower who files an individual tax return is deemed to have partial financial hardship when her payments under a standard repayment plan would exceed payments under IBR. 34 C.F.R. §§ 685.221(a).

Bankruptcy 26

- With both ICRP and IBR, accrued interest is capitalized; however, capitalization ceases once the outstanding principal amount is ten percent greater than the original principal amount.

- 34 C.F.R. § 685.209(b)(3)(iv).

Bankruptcy 27

- In November 2012, the Department of Education rolled out a new income-dependent repayment plan for certain Direct loan borrowers—the "pay-as-you-earn" plan. Pay as you earn is only available to borrowers who first received FFEL or Direct loans on October 1, 2007 or later.
- Additionally, only Direct loans disbursed after October 1, 2011 (or in the case of Direct consolidation loans applied for after October 1, 2011) are eligible for pay as you earn.

Bankruptcy 28 – Case Law on ICRP/IBR

- When a debtor is eligible for the ICRP, the court in determining undue hardship should be less concerned that future income may decline. The ICRP formula adjusts for such declines, without regard to the unpaid student loan balance, which in most cases will avoid undue hardship. ECMC v. Jesperson, 571 F.3d 775, 783 (8th Cir. 2009).

Bankruptcy 29

- **There is now a strong prejudice in the Eighth Circuit against granting a discharge of student loans through bankruptcy without the borrower first making clear and good faith efforts to investigate and undertake one or more income sensitive plans through the Department or through the lenders.**

Bankruptcy 30 – Tax Liability Issues

- Loan forgiveness offers the borrower who cannot repay his loans a way out of the student loan maze. **BUT** it has one major drawback. The Internal Revenue Code generally treats “income from discharge of indebtedness” as taxable income.
- Therefore cancellation of student loan debt can create a monumental tax liability, even 25 years down the line. Obtaining discharge through bankruptcy does not. There is no tax liability on debt discharged under the Bankruptcy Code.

Bankruptcy 31 – Collection Abuses

- http://www.nytimes.com/2014/01/02/us/loan-monitor-is-accused-of-ruthless-tactics-on-student-debt.html

- Discussing ECMC's collection and litigation strategies.

Bankruptcy 32 – In re Rose

- Although the creditors suggest Jennifer is not maximizing her earning potential and could very possibly obtain a higher-paying job with her law degree, this Court is not convinced that is true, particularly in light of the fact that it is widely recognized that the market for new attorneys today is very tight. **Moreover, based on Jennifer's presentation of this case, this Court considers it unlikely that she will obtain more lucrative employment in the foreseeable future.** In re Rose, 215 B.R. 755, 765 (Bankr. W.D. Mo. 1997)(Koger, C.J.).

Questions

- Thank you for your time and enjoy the rest of your day.