Financing Our Future: Treatment of Student Loan Debt

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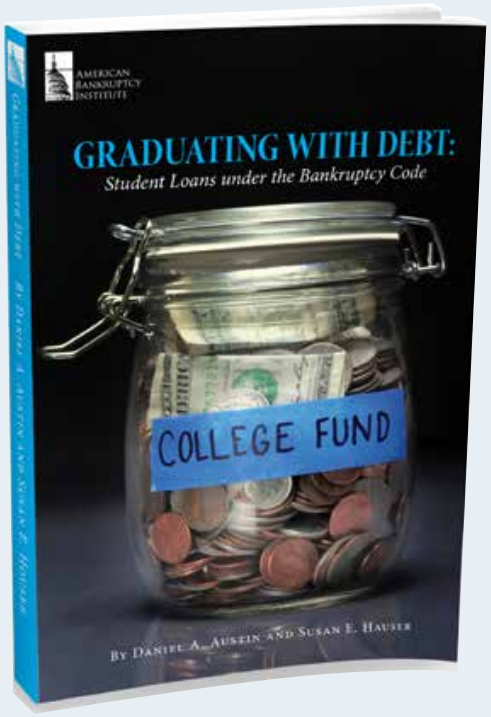

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OVERVIEW OF STUDENT LOAN ISSUES

General Information

I. Statistics

A. Americans now owe more than $1 trillion in student loan debt.

1. Greater than credit card debt and auto loans (but fewer borrowers, so the debt burden is higher).

2. More than tripled in the past decade ($364 billion in 2004 to $966 billion in 2012).

3. 1 in 10 borrowers is at least 90-days late with his or her payments.

B. Thirty-seven million Americans and 15.4% of American households hold student loan debt.

1. 7 of 10 graduating students graduated college with debt in 2014.

2. Average for undergraduate degree = more than $25,250.

3. Average for graduate degrees = more than $43,500.

C. Not just the students: Loans to parents for the college tuition of children have jumped 75% since the 2005-2006 academic year.

a. In 2012, more than 90% of private loans had co-signers, according to the Consumer Financial Protection Bureau, up from 67% in 2008.

b. Recent district court decision in Texas holds that student loan debt incurred by a debtor's friend and co-signed by the debtor was not dischargeable through the co-signer's bankruptcy. Corletta v. Tex. Higher Educ. Coordinating Bd., 2015 BL 159017, W.D. Tex.

D. For-profit colleges and trade schools

a. Are deceptive and fraudulent practices as a defense to repayment?

i. Targeting of low-income students

ii. Misrepresenting job placement statistics

iii. Coercive retention practices

b. Example: Corinthian Colleges, Inc.

II. Types of Student Loans

A. Federal

1. Stafford Loans

2. PLUS Loans

3. Perkins Loans

B. Private

III. Repayment Options

A. Deferment

B. Forbearance

C. Repayment Plans

D. Public Interest Repayment Assistance and Cancellation

IV. Consequences of Default

A. Impact on credit rating

B. Ineligibility for deferments, cancellation, consolidation programs, additional student loans and other government programs (i.e. Title IV)

C. Collection costs, fees, penalties

D. Wage garnishment, federal employee tax offsets, tax refund offsets, federal benefit offsets

V. Administrative Discharges

A. School-Related Discharges (school closure or misconduct)

B. Disability

BANKRUPTCY IMPLICATIONS

I. 11 U.S.C. §523(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 . . . .

II. History of 11 U.S.C. § 523(a):

1976: Education Act Amendments provided that a government insured or guaranteed loan could be released or discharged under the Bankruptcy Act if more than five years had elapsed since commencement of the repayment period (exclusive of any applicable suspension of the repayment period), or, if prior to the expiration of the five-year period, payment would impose an undue hardship on the debtor or his dependents. See Pub. L. No. 94-482 § 439A (Oct. 12, 1976).

1978: Section 523(a)(8) included as part of the Bankruptcy Reform Act and expanded upon the language from the Education Act Amendments to also include loans made by non-profit institutions of higher education. Five-year rule or showing of undue hardship included as well. Language was tweaked in 1979. See Pub. L. No. 95-55 (Aug. 14, 1979).

1990: Five-year rule extended to seven years, and added language for repayment obligations for funds received as an educational benefit, scholarship or stipend. See Pub. L. No. 101-647 § 3621 (Nov. 29, 1990). Previously, there was ambiguity with respect to whether § 523(a)(8) applied to scholarships and grants for which a repayment obligation arose due to the student failing to satisfy some condition. See, e.g., United States Dep't of Health & Human Services v. Smith, 807 F.2d 122 (8th Cir. 1986).

1997: The National Bankruptcy Review Commission's report recommended that § 523(a)(8) be repealed so that "most student loans are treated like all other unsecured debts." The Commission believed that the narrow construction of the undue hardship exception created an incongruity in the Bankruptcy Code that penalized individuals seeking an education while liberating others from overwhelming debt incurred for other purposes. See National Bankruptcy Review Commission's Final Report, Bankruptcy: The Next Twenty Years at § 1.4.5 (Oct 20, 1997).

1998: Seven-year rule removed, leaving only discharge for undue hardship. See Pub. L. No. 105-244 § 971 (Oct. 7, 1998).

2005: Added subparagraph (B) excepting qualified private student loans from discharge.

III. Dischargeability

A. Self-Executing: The student loan discharge exception is "self-executing", meaning that the debtor must obtain a hardship determination for a student loan to be discharged. See Tennessee Student Assistance Corp. v. Hood, 541 U.S. 440, 124 S.Ct. 1905, (2004).

B. Brunner Test – followed in 9 Circuits

1. The debtor cannot meet a minimal standard of living and repay the loans. See, e.g., In re Miller, 409 B.R. 299, 311-12 (Bankr. E.D. Pa. 2009)

2. Additional circumstances demonstrate that the debtor will not be able to repay the loans for a substantial part of the repayment period. See, e.g., Educational Credit Mgmt. v. Polleys, 356 F.3d 1302, 1310 (10th Cir. 2004) (second prong requires "a realistic look must be made into debtor's circumstances and the debtor's ability to provide for adequate shelter, nutrition, health care, and the like"). See also In re Nys, 308 B.R. 436, 444 (B.A.P. 9th Cir. 2004)

3. The debtor has attempted to repay the loans in good faith. See, e.g., Polleys, 356 F.3d at 1312 (good faith requirement does not require actual payments; rather, focus is on whether nonpayment was caused by circumstances beyond the debtor's control and whether the debtor attempted to maximize income and minimize expenses). Accord Hedlund v. Educational Resources Institute, Inc.., 718 F.3d 848, 852 (9th Cir. 2013); In re Mosko, 515 F.3d 319, 324 (4th Cir. 2008).

    a) Judicial debate regarding the availability of an income contingent repayment program plays in good faith analysis. Compare Terrence L. Michael & Janie M. Phelps, "Judges?!—We Don't Need No Stinking Judges!!!": The Discharge of Student Loans in Bankruptcy Cases and the Income Contingent Repayment Plan, 38 Tex. Tech. L. Rev. 73 (2005), with Krieger v. Educ. Credit Mgmt. Corp., 713 F.3d 882, 885 (7th Cir. 2013) (Mannion, J., concurring).

4. In some recent opinions, judges have questioned the propriety of the Brunner test: In re Roth, 490 B.R. 908, 920 (B.A.P. 9th Cir. 2013) (Pappas, J., concurring) (urging adoption of more flexible totality of circumstances test); see also In re Bene, 474 B.R. 56 (Bankr. W.D.N.Y. 2012) (discussing various ways in which Brunner test is outdated in context of applying it)

C. "Totality of the Circumstances" Test – followed in 1st Circuit and 8th Circuit – based on consideration of

1. the debtor's past, present, and reasonably reliable future financial resources

2. a calculation of the reasonable living expenses of the debtor and the debtor's dependents; and

3. any other relevant facts and circumstances. See, e.g., In re Long, 322 F.3d 549 (81h Cir. 2003)

D. Partial discharge

1. Permitted in 6th, 9th, and 11th Circuits. See, e.g., In re Miller, 377 F.3d 616 (6th Cir. 2004); In re Saxman, 325 F.3d 1168 (9th Cir. 2003);

2. Perhaps permitted in 10th and 11th Circuits. See, e.g., In re Alderete, 412 F.3d 1200 (10th Cir. 2005) (denying partial discharge based entirely on

exercise of §105(a) power without a finding of undue hardship); In re Cox, 338 F.3d 1238 (11th Cir. 2003) (same)

D. Substance of the Transaction Test

1. Test used to determine whether a loan constitutes a student loan for purposes of dischargeability under 11 U.S.C. § 523(a)(8) and focuses on the "stated purpose for the loan when it was obtained, rather than how the proceeds were actually used by the borrower." In re Rumer, 469 B.R. 553, 562 (Bankr. M.D.Pa. 2012).

2. Guards against possibility for discharge when student used funds for non-educational purposes. See In re Busson-Sokolik, 635 F.3d 261, 266 (7th Cir. 2011).

3. No requirement that borrower be enrolled as a student full time. See Roy v. Sallie Mae, 2010 WL 1523996 at *1 (Bankr. D.N.J. Apr. 15, 2010).

IV. Litigation Issues

A. Burdens of Proof

1. Initial burden of proving existence/validity of debt and that it falls within §523(a)(8). See, e.g., In re Rumer, 469 B.R. 553 (Bankr. M.D. Pa. 2012).

2. But debtors have burden of proving undue hardship. See, e.g., In re Faish,72 F.3d 298, 301 (3d Cir. 1995); Jesperson, 571 F.3d at 779

B. Is Expert testimony necessary?

1. Regarding conditions (usually medical) that debtor contends establish the second Brunner prong (i.e., inability to repay the loans without undue hardship will continue for a substantial part of the repayment period)?

2. In re Brightful, 267 F.3d 324, 329-30 (3d Cir. 2001) (no per se expert testimony requirement); accord In re Mosley, 494 F.3d 1320, 1325-26 (11th Cir. 2007); In re Barrett, 487 F.3d 353, 362-63 (6th Cir. 2007)

3. See also In re Crawley, 460 B.R. 421, 440-42 (Bankr. E.D. Pa. 2011) (discussing evidentiary value of lay testimony)

C. Servicers

1. Lenders often engage servicers to collect repayment from borrowers. The servicers are often the first point of contact for the borrowers and are frequently named in adversary proceeding complaints to discharge student loan debt.

2. Servicers typically do not own or hold the loan, and thus judgment against a servicer in a non-discharge action would be ineffective. See, e.g., In re Srinivasan, 2010 WL 3633062 at *3 (Bankr. D.N.J. Sep. 7, 2010); In re Alabdulrasul 2012 WL 1597277 (Bankr. N.D. Iowa May 7, 2012); Holmes v. Educ. Credit Mgmt. Corp., 2012 WL 1605940 at *2 (N.D.Fla. Apr. 4, 2012).

V. Chapter 13 Plans - Discrimination in Favor or Student Loan Claims

A. Statutory provisions

1. 11 U.S.C. § 1322(b)(1)

   (a) the plan may ***"designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims"***

2. 11 U.S.C. § 1322(b)(5)

   (a) the plan may ***"provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due"***

3. 11 U.S.C. § 1322(b)(10)

   (a) the plan may ***"provide for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are nondischargeable under section 1328(a), except that such interest may be paid only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims"***

B. Unfair Discriminations Tests

> ***"We haven't been able to think of a good test ourselves . . . . We conclude, at least provisionally, that this is one of those areas of the law in which it is not possible to do better than to instruct the first-line decisionmaker, the bankruptcy judge, to seek a result that is reasonable in light of the purposes of the relevant law, which in this case is Chapter 13 of the Bankruptcy Code.***
>
> **Judge Richard Posner, In re Crawford, 324 F.3d 539, 542 (7th Cir. 2003)**

1. Leser/Wolf test

   (a) Based on In re Leser, 939 F.2d 669 (8th Cir. 1991) and In re Wolf, 22 B.R. 510 (B.A.P. 9th Cir. 1982)

   (b) Four part test:

      1) the discrimination has a reasonable basis

      2) the debtor can carry out a plan without the discrimination

      3) the discrimination is proposed in good faith; and

      4) the degree of discrimination is directly related to the basis or rationale for the discrimination

2. "Legitimate interests of the debtor" test

   (a) See In re Lawson, 93 B.R. 979, 984 (Bankr. N.D. Ill. 19880). But see McCullough v. Brown, 162 B.R. 506 (N.D.Ill.1993), rev'g 152 B.R. 232 (Bankr. N.D. Ill. 1993)

3. Bentley test

   (a) based on In re Bentley, 266 B.R. 229 (B.A.P. 1st Cir. 2001)

   (b) requires consideration of four (4) specific chapter 13 "baselines" and a determination whether there is any benefit to the disfavored class that bears a reasonable relationship to the deviation from the baselines

   (c) the baselines are:

1) the principle of equality of distribution

2) the non-priority status of student loan debts

3) the mandatory nature of the debtor's obligation to devote projected disposable income to the payment of unsecured debt

4) the Code's fresh start policy, tempered by the nondischargeability of certain debts (like student loans)

C. Selected Issues

1. Maintenance of student loan payments under §1322(b)(5)

   (a) Minority view permits: In re Johnson, 446 B.R. 921 (Bankr. E.D. Wis. 2011); see also In re Brown, 500 B.R. 255, 264 (Bankr. S.D. Ga. 2013) (collecting cases, but then rejecting the minority view)

   (b) Majority view requires discrimination to be "fair" under §1322(b)(1). See, e.g., In re Jordahl, 516 B.R. 573 (Bankr. D. Minn. 2014 (collecting cases)

   (c) Minority view permits this based on treatment of student loan contractual payments as permitted "special circumstances" expense under the "means test," 11 U.S.C. §707(b)(2(B)), incorporated in chapter 13 by §1325(b)(3). See In re Howell, 477 B.R. 314 (Bankr. W.D.N.Y. 2012); In re Knight, 370 B.R. 429 (Bankr. N.D. Ga. 2007); see also In re Pageau, 383 B.R. 221 (Bankr. D.N.H. 2008); In re Delbeq, 368 B.R. 754 (Bankr. S.D. Ind. 2007).

   (d) Majority view rejects nondischargeability of student loan debt as basis for allowing it as a "special circumstances" expense. See In re Martin, 505 B.R. 517 (Bankr. S.D. Iowa 2014); Brown, 500 B.R. at 261-63 In re Maura, 491 B.R. 493 (Bankr. E.D. Mich. 2013); In re Harmon, 446 B.R. 721 (Bankr. E.D. Pa. 2011); In re Carillo, 412 B.R. 540 (Bankr. D. Ariz. 2009)

2. Use of income that is not "projected disposable income"

(a) In re Knowles, 501 B.R. 409 (Bankr. D. Kan. 2013);In re Abaunza, 452 B.R. 866 (Bankr. S.D. Fla. 2011); In re Orawsky, 387 B.R. 128 (Bankr. E.D. Pa. 2008)

3. Degree of impairment of disfavored class

(a) For a collection of cases involving plan providing 100% payment of student loan debt and varying percentage distributions to other unsecured creditors, see 6 A.L.R. Fed.. 2d 507, §§26-32 (West 2015)

4. Consideration of post-discharge consequences to the debtor

(a) See In re Bosaccy, 442 B.R. 501 (Bankr. N.D. Miss. 2010); In re Webb, 370 B.R. 418 (Bankr. N.D. Ga. 2007); see also In re Pracht, 464 B.R. 486 (Bankr. M.D. Ga. 2012)

5. Effect of §1322(b)(10)

(a) A number of courts have held that §1322(b)(10) precludes confirmation of any plan that provides for maintenance of payments even if there is no unfair discrimination. In re Stull, 489 B.R. 218 (Bankr. D. Kan. 2013): held . Accord In re Precise, 501 B.R. 67 (Bankr. E.D. Pa. 2013); In re Kubeczko, 2012 WL 2685115 (Bankr. D. Colo. July 6, 2012); In re Edmonds, 444 B.R. 898 (Bankr. E.D. Wis. 2010).

(b) Other courts disagree. See In re Brown, 500 B.R. 255 (Bankr. S.D. Ga. 2013) (reasoning that §1322(b)(5) allows interest on secured and unsecured long term debt and § 1322(b)(10) restricts interest payments on non-dischargeable unsecured debts that are not eligible for cure and maintenance under § 1322(b)(5), such as debts that are non-dischargeable due to a debtor's fraud) (citing cases)

VI. Transfer Avoidance of Educational Expenses Paid Pre-Petition

A. Trustees are increasingly attempting to recover student loan and tuition payments, including under 11 U.S.C. § 548 and state fraudulent conveyance statutes to avoid payments made by parents for their children's education on the premise that the parents did not receive reasonably equivalent value in exchange for the payments.

B. Noteworthy cases - Results have been mixed and may turn on nuances of state law:

1. In re Johnson, 371 B.R. 380 (Bankr. E.D. Ark. 2007): Judgment entered against debtors under 11 U.S.C. § 105(a) for prepaid tuition to their children's parochial schools as the funds constituted estate property.

2. In re Lindsay, 2010 WL 1780065 (Bankr. S.D.N.Y. May 4, 2010): Trustee able to avoid parents' college tuition payments for their son as the parents could not establish that they received fair consideration for the transfers

3. In re Leonard, 454 B.R. 444 (Bankr. E.D. Mich. 2011): Debtors' pre-petition college tuition payments for their son could be avoided under 11 U.S.C. § 548(a)(1) because the debtors did not have a legal obligation to provide a college education for their son and could not demonstrate that they received any "concrete and quantifiable benefit."

4. In re Karolak, 2013 WL 4786861 (Bankr. E.D. Mich. Sept. 6, 2013): Trustee could not avoid tuition payments from the private school of the debtor's children because the debtor received reasonably equivalent value through fulfilling her obligation under state law to provide schooling for her children. Distinguished from In re Leonard because that case involved college tuition payments for an adult child, whereas this case involved tuition payments for minor children.

5. In re Cohen, 2012 WL 5360956 (Bankr. W.D. Pa. Oct. 31, 2012), *rev'sd on other grounds*, 487 B.R. 615 (W.D.Pa. 2013): Tuition payments for a child's undergraduate education were considered "reasonable and necessary for the maintenance of the Debtor's family." Holding did not extend to tuition for graduate school.

6. In re Oberdick, 490 B.R. 687 (Bankr. W.D. Pa. 2013): Added to In re Cohen that there is a "societal expectation" that parents will assist in paying for college tuition for their children. Such payments were necessities and could not be avoided under state law absent evidence that the transfers were made to shield the funds.

7. In re Akanmu, 502 B.R. 124 (Bankr. E.D.N.Y. 2013): Trustee could not avoid tuition payments made by the debtors to their children's parochial school as parents have an obligation to provide education for their children under state law and as a matter of common sense, and that the trustee was not entitled to scrutinize the debtors' choice of education for their children.

C. Potential Legislation – Recently proposed bill would amend 11 U.S.C. § 548 to make payments made by a parent for his/her child non-avoidable transfers. See H.R. 2267 – PACT (Protecting All College Tuition) Act of 2015.

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