

ABI Members Testify on Discharging Student Loan Debt in Bankruptcy

Editor's Note: On Sept. 23, 2009, the House Judiciary Committee's Subcommittee on Commercial and Administrative Law held a hearing on "An Undue Hardship? Discharging Educational Debt in Bankruptcy." The witnesses were: Hon. Danny K. Davis, U.S. House of Representatives, 7th District, Illinois; Lauren Asher, President, The Institute for College Access and Success, Berkeley, Calif.; **Rafael I. Pardo**, Associate Professor of Law, Seattle University School of Law, Seattle, Wash.; **J. Douglas Cuthbertson**, Miles & Stockbridge PC, McLean, Va.; and Brett Weiss, Joseph, Greenwald & Laake PA, Greenbelt, Md. This Legislative Update column features excerpts from the written testimony of Prof. Pardo and Mr. Cuthbertson, both of whom are ABI members. For their full testimony and for the statements of the non-ABI member witnesses, please go to http://judiciary.house.gov/hearings/hear_090923_1.html. ABI is a nonpartisan organization dedicated to research and education on matters related to insolvency. The statements of these ABI members reflect their views and/or positions, or those of their firms, not those of the ABI.

Testimony of Rafael I. Pardo

Seattle University School of Law; Seattle
pardor@seattleu.edu

I am pleased to testify in support of any legislation that would restore the unconditionally dischargeable status of private student loans in bankruptcy that existed prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).¹ As student-loan defaults and bankruptcy filings continue to rise in the current economic downturn,² more student-loan borrowers will inevitably find themselves within the bankruptcy system seeking forgiveness of their debt.

¹ In using the phrase "private student loan," I am specifically referring to an "educational loan that is a qualified education loan, as defined in §221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual." 11 U.S.C. §523(a)(8)(B) (2006). Congress amended the Bankruptcy Code in 2005 to include such loans among the types of educational debt that can be discharged only upon a showing of undue hardship. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, §220, 119 Stat. 23, 59 (codified at 11 U.S.C. §523(a)(8)(B)). Prior to 2005, such debts were automatically dischargeable in bankruptcy. See 11 U.S.C. §523(a)(8) (2000) (amended 2005).

² See, e.g., Tara Siegel Bernard and Jenny Anderson, "Downturn Drags More Consumers into Bankruptcy," *N.Y. Times*, Nov. 16, 2008, at A1; Anne Marie Chaker, "Student Loans: Default Rates Are Soaring," *Wall St. J.*, April 21, 2009, at D1; Tamar Lewin, "Student Loan Default Rate Rises," *N.Y. Times*, Sept. 15, 2009, at A14.

Unfortunately, many of them, including some who are among the most desperate for relief, are unlikely to get the fresh start that the bankruptcy system promises other types of individual debtors.



Rafael I. Pardo

The general rule in bankruptcy is that all prebankruptcy debts are discharged—that is, a debtor will no longer be personally liable for such debts after emerging from bankruptcy. This represents bankruptcy's fresh start for debtors. The Bankruptcy Code, however, singles out certain types of debts as nondischargeable (e.g., debts for certain income taxes; debts for alimony, maintenance, and child support). Debts for student loans are exceptional insofar as they are the only type of debt that is *conditionally* dischargeable in bankruptcy—that is, the debt is not automatically discharged

proceeding requires substantial monetary resources, debtors in bankruptcy, already in financial distress, face additional hurdles in obtaining a discharge of their student loans.

...
My written testimony makes the following major points:

1. Empirical evidence suggests that student-loan debtors who seek a discharge of educational debt in bankruptcy suffer from severe financial distress.
2. The legal standard for discharging educational debt in bankruptcy, undue hardship, is currently undefined by the Bankruptcy Code. As such, the standard provides minimal guidance to litigants and judges. This produces differential treatment of similarly situated debtors, with some granted a discharge and others denied a discharge.
3. Legally irrelevant factors that should not bear on the merits of a debtor's claim for relief, such as the

Legislative Update

but can be upon the satisfaction of a certain condition. If a debtor establishes that repayment of the student-loan debt would impose an undue hardship, the debt will be discharged.³ Accordingly, the Bankruptcy Code requires a court to determine whether a debtor's circumstances warrant forgiveness of such debt.

There are two issues that are of particular concern with the process for discharging student loans in bankruptcy. First, the discharge standard for student loans, undue hardship, is undefined by the Bankruptcy Code. Because it is a vague and indeterminate standard, concerns arise that similarly situated debtors will obtain differential treatment given the inherent subjectivity of the standard. Second, for a debtor to obtain a discharge of student loans, the debtor must initiate an adversary proceeding against the creditor—essentially, a full-blown lawsuit. Because bringing such a

level of experience of the debtor's attorney and the identity of the judge assigned to the debtor's case, appear to affect whether a debtor obtains a discharge of his or her student loans. Accordingly, the procedural hurdles that student-loan debtors confront in litigating their claims of undue hardship further exacerbate the problem of inconsistent outcomes.

4. Private student loans are largely unregulated. Without limits on the amount that students can borrow, with limited options for repayment relief, and with variable interest rates, borrowers of such loans often find themselves deeply mired in debt.⁴ In 2005, when Congress removed the unconditionally dischargeable status of such loans in bankruptcy, it stripped away the social safety

⁴ See Sandra Block, "Private Student Loans Pose Greater Risk," *USA Today*, Oct. 25, 2006, at 1B; Diana Jean Schemo, "With Few Limits and High Rates, Private Loans Deepen Student-Debt Crisis," *N.Y. Times*, June 10, 2007, at A28.

³ 11 U.S.C. §523(a)(8) (2006).

continued on page 66

Legislative Update: ABI Members Testify on Discharging Student Loan Debt

from page 10

net available to the borrowers of such loans. In the absence of robust nonbankruptcy relief from private student loans, it stands to reason that the negative effects of litigating claims of undue hardship will fall disproportionately on debtors with such loans.

The Disproportionate Impact of Undue Hardship Discharge on Private Student Loans

In recent years, private student loans have increasingly grown as a source of funding for students' higher education costs.⁵ The increased reliance on private student loans can be attributed to the effort of borrowers and their families to close the gap between education costs and other available sources of funding—a gap that has widened as a result of (1) rising tuition rates that have outpaced the rate of inflation, (2) limited amounts of federal aid and scholarship aid, (3) stagnant incomes and (4) reduced savings (including the disappearance of home equity against which families can borrow).⁶ Due to the absence of other options for pursuing the promise of higher education, borrowers of private student loans unfortunately end up facing higher risks than do borrowers of federal student loans:

With private loans, options for handling overwhelming debt burden are more limited in comparison to federal loans, and lenders are not mandated to offer any particular relief... Understanding the impact of the availability of economic hardship relief is particularly important for students with the lowest incomes or independent students paying for their own college expenses, a group to which the private loan industry is increasingly reaching out.⁷

In more blunt terms, New York State Attorney General Andrew M. Cuomo has referred to private student loans as the “Wild West of the student loan industry.”⁸

[T]he Bankruptcy Code provides independent mechanisms for a court to police abuse of the bankruptcy system by student-loan debtors... criticisms of making private student loans automatically dischargeable in bankruptcy are likely to be unfounded and should therefore fall on deaf ears.

Because the costs of private student loans can quickly spiral out of control, and because there exist limited nonbankruptcy options for mitigating the financial distress imposed by such costs, borrowers of private student loans are particularly vulnerable to the negative effects of undue-hardship discharge litigation. If they end up seeking relief through the bankruptcy system and subsequently fail to prevail in their claim of undue hardship, they will find themselves struggling interminably under an oppressive amount of educational debt with little to no other options for relief. By stripping away the one social safety net that existed for borrowers of private student loans—that is, the automatic discharge of such loans in bankruptcy—Congress has likely condemned certain student-loan debtors to the Sisyphean task of repaying obligations that will never be extinguished.

Proposed Solutions

In light of my foregoing testimony, I respectfully urge Congress to restrike the balance between student-loan debtors and lenders of private student loans by restoring the automatically dischargeable status of private student loans in bankruptcy. Doing so would

provide borrowers of such loans with a much-needed social safety net.

Critics of such a proposal are likely to respond that making private student loans automatically dischargeable in bankruptcy will have the negative effects of (1) decreasing the availability of private student loans due to the increased availability of the discharge of such loans and (2) encouraging abuse of the bankruptcy system by borrowers of such loans. In response to the former point, existing empirical research indicates that, subsequent to BAPCPA's enactment and the reduced availability of the discharge of private student loans, the availability of such loans increased only slightly and only for borrowers with the lowest credit scores.⁹ In other words, economic theory aside, the market for private student loans appears to be predominantly insensitive to the risk of bankruptcy discharge.

In response to the latter point, first and foremost, the pecuniary and nonpecuniary costs associated with a bankruptcy filing likely prompt debtors to view bankruptcy relief as an option to be exercised only in the most dire of circumstances rather than an easy fix to their financial distress.¹⁰ Moreover, the Bankruptcy Code provides independent mechanisms for a court to police abuse of the bankruptcy system by student-loan debtors. If a student-loan debtor files for chapter 7 relief in bad faith, this provides a basis for the court to dismiss the debtor's case;¹¹ and if a student-loan debtor files for chapter 13 relief in bad faith, this too provides a basis for the court to dismiss the debtor's case.¹² Accordingly, criticisms of making private student loans automatically dischargeable in bankruptcy are likely to be unfounded and should therefore fall on deaf ears.

⁵ Inst. for Higher Educ. Policy, “The Future of Private Loans: Who Is Borrowing, and Why?,” 1 (2006); Block, *supra* note 6; Schemo, *supra* note 6.

⁶ See Inst. for Higher Educ. Policy, *supra* note 30 at 13; Jonathan D. Glater, “College Costs Outpace Inflation Rate,” *N.Y. Times*, Oct. 23, 2007, at A23; Jonathan D. Glater, “Fewer Options for Paying Costs of College,” *N.Y. Times*, April 12, 2008, at A1; Jonathan D. Glater, “In a Downturn, College Strains Family Budgets,” *N.Y. Times*, Oct. 17, 2008, at A1; Jonathan D. Glater, “Scholarships for College Dwindle as Providers Pull Back Their Support,” *N.Y. Times*, June 27, 2009, at A8; Tamar Lewin, “Higher Education May Soon Be Unaffordable for Most Americans, Report Says,” *N.Y. Times*, Dec. 3, 2008, at A19.

⁷ Inst. for Higher Educ. Policy, *supra* note 30 at 11.

⁸ “Paying for College: The Role of Private Student Lending,” Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (June 6, 2007) (written testimony of Andrew M. Cuomo, State of N.Y. Atty Gen., at 3), available at http://banking.senate.gov/public/_files/cuomo.pdf.

⁹ See Mark Kantrowitz, “Impact of the Bankruptcy Exception for Private Student Loans on Private Student Loan Availability,” (2007), available at www.finaid.org/educators/20070814psfICODistribution.pdf.

¹⁰ In terms of pecuniary costs, future extensions of credit may be more difficult for a debtor to obtain postbankruptcy. See Katherine Porter and Deborah Thorne, “The Failure of Bankruptcy’s Fresh Start,” 92 *Cornell L. Rev.* 67, 122 (2006). In terms of nonpecuniary costs, debtors must struggle with the stigma associated with filing for bankruptcy. See Teresa A. Sullivan, Elizabeth Warren and Jay Lawrence Westbrook, “Less Stigma or More Financial Distress: An Empirical Analysis of the Extraordinary Increase in Bankruptcy Filings,” 59 *Stan. L. Rev.* 213 (2006) (concluding that, over 20-year period, stigma of bankruptcy has increased).

¹¹ See 11 U.S.C. §707(b)(1) (2006) (providing for dismissal of chapter 7 case on the basis of abuse); *id.*; §707(b)(3)(A) (providing that bad-faith filing of chapter 7 petition can constitute abuse).

¹² See *id.*; §1325(a)(7) (providing that court may not confirm chapter 13 plan unless “the action of the debtor in the filing the petition was in good faith”); *id.* §1307(c)(5) (providing that denial of confirmation of chapter 13 plan constitutes cause for dismissing debtor’s 15 chapter 13 case). For the argument that, as a statutory matter, a debtor’s good faith is an improper consideration in analyzing a claim of undue hardship, see Pardo and Lacey, “Undue Hardship in the Bankruptcy Courts,” *supra* note 1, at 514-19.

Testimony of J. Douglas Cuthbertson
Miles & Stockbridge PC; McLean, Va.
jcuthbertson@milesstockbridge.com

I am counsel for the National Council of Higher Education Loan Programs Inc. and several guaranty agencies under the Federal Family Education Loan Program (FFELP) as *amici curiae* in support of the petition for *writ of certiorari* in the case of *United Student Aid Funds Inc. v. Espinosa*, which is pending before the Supreme Court.



J. Douglas Cuthbertson

... The exception to discharge for educational loans is one of many exceptions in the Bankruptcy Code to the general goal of a “fresh start” for debtors. Congress created these exceptions to the general rule of dischargeability because it believed that the creditors’ interest in recovering full payment of debts in these categories outweighs the debtors’ interest in a complete fresh start.

The exception to discharge for educational loans is codified at 11 U.S.C. §523(a)(8). Congress enacted the exception in the 1970s in response to bankruptcies in which recent graduates filed for relief based primarily on student loan debt. The nondischargeability provision has two goals: (1) maintaining the financial integrity of the student loan system, and (2) curbing abuse by recent graduates, who have their whole lives of earning capacity before them.

One reason for the exception was the underwriting criteria of student lenders. Historically, student lenders have underwritten and funded private educational loans looking toward the student’s future earning capacity as a source of repayment. Lenders making FFELP loans have no true underwriting criteria. With some exceptions, if a student is enrolled in a degree-granting program of an approved educational institution, he or she can receive a FFELP loan up to the maximum amount. In contrast, lenders that make other commercial and personal loans generally look to a borrower’s current ability to repay and the value of collateral (such as a car or a house) securing the loan. Neither of these criteria is present in most educational loans.

The congressional purposes of maintaining the financial integrity and preventing abuses of the student loan

system apply equally to both FFELP loans and private loans. Without the undue-hardship standard, borrowers could enjoy the benefits of their education and file bankruptcy without ever attempting to repay, leaving lenders with no assets or other way to get repaid. Essentially, borrowers would be converting a student loan (whether FFELP or private) into a scholarship. With respect to private loans, removing the exception to discharge would have one of three effects: (1) lenders would decide to no longer make private loans—a real concern in this credit environment; (2) private loan lenders would increase interest rates or insist on a co-borrower; or (3) borrowers could choose to take out private loans rather than FFELP loans with the intent to discharge all of the loans after graduation. In other words, students may have a motivation to take out a higher-cost private loan over a lower-cost FFELP loan, thus damaging the integrity of the educational loan system.

Removing the exception to discharge for educational loans would tighten credit, decrease access to education, reduce responsibility and accountability, and drive lending into the public sector... Congress instead should focus its efforts on taking action to help reduce rising educational costs and increasing post-graduation employment.

Moreover, abrogating the exception to discharge for educational loans would be unfair to student lenders. Lenders who have served in the FFELP program have put their capital and work into the program predicated on the existing limitations on dischargeability. The same is true of lenders making private-sector loans. These limitations have, in turn, been leaked into the pricing structure for securitizations, or at least no allowance has been made for dischargeability features in respect of these securitizations.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) amended §523(a)(8) to include an exception to discharge for “qualified education loans.” The definition of qualified

education loan includes most, but not all, private student loans. Thus, Congress treated FFELP and private loans the same. Private loans generally supplement FFELP loans. But due to the rapidly rising cost of higher education, private loans are an important source of educational funding for students. Removing the undue hardship standard for private loans would increase the cost of private student loans and decrease access to higher education.

... As with any factually intensive inquiry in our system of civil litigation, the trier of fact—here, a bankruptcy judge—is best situated to decide the issue of whether a student loan debt is an undue hardship on a debtor in light of the particular circumstances of each case. Courts have not required debtors to live at the poverty level in order to discharge their student loans. They also take into account a debtor’s good-faith effort to repay his or her student loans. Because of the factually-intensive nature of the inquiry, in some cases, debtors are granted a discharge, and in others, they are not. But that is how Congress wrote the law, and the courts are obligated to follow it. Congress may give further direction reforming the undue-hardship standard to ensure that it is being applied in a uniform manner in bankruptcy courts throughout the country. But the substantial body of law that has been developed in this area has proven to be workable and effective in preserving Congress’ balanced goals of hardship discharge, while giving debtors a fresh start in bankruptcy.

... Importantly...debtors who are unable to pay loans originated in the federal student loan programs are not without redress for an overburdening set of economic circumstances occasioned by student loan debt load. There are various forms of borrower benefits relating to income, health and public service that allow borrowers to mitigate the effects of student loan debt. The most recent of these is Income-Based Repayment, established to provide borrowers within the FFELP program a way to make lowered payments.

... Removing the exception to discharge for educational loans would tighten credit, decrease access to education, reduce responsibility and accountability, and drive lending into the public sector. As a result, Congress instead should focus its efforts on taking action to help reduce rising educational costs and increasing post-graduation employment. ■