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Student Loans In and Out of Bankruptcy

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Many Americans experience financial hardship due to student loan obligations. Bankruptcy would seem to be an appropriate remedy for this problem, but student loan borrowers must prove "undue hardship" to discharge student loan debts. This paper investigates the options and requirements for student loan mitigation, both in and out of bankruptcy.

I. History of Discharge of Student Loans in Bankruptcy

Before the enactment of the Bankruptcy Code, student loans were dischargeable in bankruptcy, just as any other consumer debt. Since the Code's enactment, Congress has made the discharge of student loans in bankruptcy increasingly difficult.

Starting in the 1970s, concerns were raised that graduates with high income potential could file for bankruptcy immediately after graduation to rid themselves of student loan debt that they had the ability to repay. The Congressional Commission on the Bankruptcy Laws of the United States was formed in 1970 and its report was issued in 1973. Among the Commission's recommendation was a provision that government-backed student loans should be barred from discharge for a five-year period following commencement of repayment. It also established a standard of undue hardship to discharge student loan debt prior to expiration of the five-year period. Congress then commissioned a study by the Government Accountability Office regarding student loan discharge rates. The GAO study found that while 18% of student loans were in default, less than 1% were discharged in bankruptcy. Although the GAO study appeared to disabuse the notion that high-income-earning debtors were filing for bankruptcy protection to discharge large amounts of student loan debt, the Education Amendments Act of 1976 was passed to adopt the Bankruptcy Commission's recommendations and to bar discharge of qualified student loans, absent undue hardship, for a period of five years from the date payments commenced.

In 1978, the student loan exception to discharge was moved from the Higher Education Act to the Bankruptcy Code at 11 U.S.C. § 523(a)(8) with the passage of the Bankruptcy Reform Act.

In 1978, the Bankruptcy Amendments and Federal Judgeship Act of 1984 broadened the discharge exception of student loans to include private loans backed by nonprofit institutions as well as government-backed loans.

In 1990, Congress extended the time a student loan discharge was barred, absent undue hardship, to seven years from date of commencement of repayment.

In 1998, Congress acted further under Higher Education Acts to remove the 7-year time limit for the student loan discharge bar, thereby requiring a showing of undue hardship to discharge a government-backed loan or private loan backed by a nonprofit institution.

In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act expanded the type of student loans excepted from discharge, absent a showing of undue hardship – all qualified loans, including most private loans, were now excepted from discharge, including private student loans not affiliated with a nonprofit institution unless the debtor proved undue hardship.

Over the past decade, the volume of outstanding student loans has grown considerably. U.S. student loan debt is now the second highest consumer debt category – behind only mortgage debt – and higher than credit cards and auto loans. According to a 2020 CBO publication, between 2018 and

2019 the U.S. government issued $76 billion in new loans to 7.6 million students. As of December 2018, outstanding student loans issued or guaranteed by the federal government totaled $1.4 trillion—or 6.8% of GDP. According to the *Federal Reserve & New York Federal Reserve, as of 3Q 2019*, approximately 5.5 million borrowers had approximately $119.8 billion in default. Texas currently has the highest outstanding student loan debt in the U.S. As of Q4 2019, Texas had 3.4 million borrowers owing $107.3 billion.

II. Undue Hardship in Bankruptcy

Congress failed to define what undue hardship meant when section 523(a)(8) was created. Two tests to access the undue hardship standard evolved as a result of the vague wording: (1) the *Brunner* test and (2) the totality of the circumstances test.

A. The *Brunner* Test

The Second Circuit's opinion in *Brunner v. New York Higher Education Services Corporation*, 831 F.2d 395 (2d Cir. 1987), is the principal test for determining whether a debtor has shown that repayment of a student loan would create an undue hardship. The *Brunner* test requires that each of the three following elements be proven by a preponderance of the evidence: "(1) that the debtor cannot maintain, based on current income and expenses, a 'minimal' standard of living for herself and her dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans." *Id.* at 396.

The Fifth Circuit adopted the *Brunner* three-prong test in *United States Department of Education. v. Gerhardt* (*In re Gerhardt*), 348 F.3d 89 (5th Cir. 2003). The Fifth Circuit recently stated in *Thomas v. Department of Education* (*In re Thomas*), 931 F.3d 449, 555 (5th Cir. 2019), that "student loans are not to be discharged unless requiring payment would impose intolerable difficulties on the debtor." The debtor must satisfy each prong of the *Brunner* test by a preponderance of the evidence. If even one prong of the test is not satisfied, the debt is not dischargeable. *See In re Lewis*, Case No. 17-51357, Adv. No. 17-06060, 2020 WL 489222, at *3 (Bankr. S.D. Miss. Jan. 29, 2020). Thus, successfully discharging student loan debt is extremely difficult.

An understanding of the facts of the case helps make sense of the ruling in *Brunner*. The debtor received a bachelor's degree in social work in 1979 and a master's degree in 1982. She filed for Chapter 7 bankruptcy protection seven months after receiving her master's degree. Her student loan indebtedness totaled $9,000. Representing herself, she sought to discharge her student loans as imposing an undue hardship. The bankruptcy court ruled in her favor in an oral ruling. The student loan servicer appealed to the district court, who overturned the bankruptcy court decision and determined that repayment of the student loan did not impose an undue hardship on the debtor. The debtor, again representing herself, appealed to the Second Circuit who affirmed the district court decision and created the now often cited "*Brunner* test."

1. The First Prong – Inability to Maintain "Minimal" Standard of Living

The first prong of the *Brunner* test requires that the debtor show he cannot maintain, based on current income and expenses, a minimal standard of living for himself and his dependents if forced to repay the loans. *Brunner*, 831 F.2d at 396. Courts conduct this analysis by reviewing the disparity

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