Is Discharging Student Loan Debt in Bankruptcy Getting Easier?

By Paul B. Porvaznik

After reading Steven Harper's well-written and researched *The Lawyer Bubble*,[1] my immediate reaction was, "And this is news? Why?"

Harper describes the pathology that afflicts the legal job market. He singles out the impact of crushing student loan debt on law grads and how a vicious cycle of lending, borrowing, and debt perpetuates itself. Harper rightly points out that too many law graduates are consigned to a life of financial strain with little chance of escape.

So why my nonplussed reaction? Because everything Harper recounts in the book was true in 1996 when I graduated. Maybe not to the same level, but it was all there. The law schools' frantic chase for favorable *U.S. News and World Report* rankings, convulsive lending and borrowing with little thought of repayment, students' unrealistic expectations ("I'll make law review if I apply myself"), and the juvenile reasons for going to law school in the first place ("I need another three years to find myself"). All these factors existed then and apply with even greater force nearly two decades later.

The popular narrative on discharging student loans in bankruptcy, whether for law school or otherwise, is dogmatic:

1. Steven J. Harper, The Lawyer Bubble: A Profession in Crisis (2013).

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The "undue hardship" standard for discharging student loan debt is widely viewed as nearly impossible to meet. But as cases from across the country suggest, the tide may be turning in favor of a more relaxed, fact-specific test, and whether you can discharge student loan debt depends more and more on where you happen to be.

"Student loans can only be discharged in the most extreme situations – don't bother unless you meet the ultra-high burden. And you don't."

But the conventional wisdom is less wise these days. This article summarizes some recent cases in various jurisdictions that have weighed in on the issue. I describe the prevailing tests used in various federal circuits – including our own seventh circuit – and try to find some linking strands among cases that allow and disallow student loan discharge.

How student loans became (almost) nondischargeable

According to the federal fourth circuit, student loans are protected from discharge because Congress and the courts view the student lender-borrower relationship as a quid pro quo: the lender provides the resources to obtain an education and the borrower returns the favor by repaying the loans.[2] Protecting student loans from discharge ensures the integrity of the system and saves it from economic ruin.[3]

The toughening of the Code. *In re Myhre*, a 2013 Wisconsin bankruptcy case, provides a concise history of how student loan debt has been treated under federal bankruptcy law and by courts applying the law.[4] Before 1978, student loans were freely dischargeable. However, because of concerns that too many students were filing for bankruptcy protection shortly after graduation, the Bankruptcy Code was amended to exempt student loans made by government or nonprofit entities that came due within five years of the bankruptcy filing unless payment caused an undue hardship. Under the amendment, once that five-year period lapsed, the student loan debt would be dischargeable.

The Code was amended again in 1987 to increase the discharge period from five to seven years before a debtor could seek a student loan discharge (that is – a bankruptcy filer couldn't seek a student loan discharge until seven years passed from the time the loan was due).[5] Then, in 1995, the Code was amended to state the blanket rule that student loans were nondischargeable unless the borrower-debtor could show undue hardship.

Congress amended the Code again in 2005 when it exempted private (as opposed to government) student loans from automatic discharge and made those loans (private) also subject to the undue hardship test. But as we'll see below, courts are reinterpreting the undue hardship test to soften the brittle Code provisions.

Bringing a challenge. Under the current bankruptcy law, when a debtor has completed repayments required by a confirmed plan, the court must discharge the debtor from all debts except those specified in Section 523(a)(8).[6] That section provides that certain student loan debts are nondischargeable unless they impose an "undue hardship" on the debtor and the debtor's dependents.[7]

Procedurally, to have a student loan deemed dischargeable, the debtor files an adversary proceeding against the affected lender/creditor and serves the lender with summons and the complaint.[8] The lender then has the opportunity to contest the discharge attempt. The following sections discuss how courts have interpreted the undue hardship test, often in ways that benefit harried debtors (see sidebar for summaries of recent student loan discharge cases).

The conventional wisdom on discharging student loans in bankruptcy – that it can be done in only the most extreme situations – is less wise these days.

Undue hardship: The *Brunner* test

The watershed undue hardship case is *Brunner*

2. *In re Frushour*, 433 F.3d 393 (4th Cir. 2005).
3. *Id.* at 400.
4. *In re Myhre*, 503 B.R. 698 (Bankr. W.D. Wisc. 2013).
5. *Id.* at 703.
6. 11 U.S.C. §§ 523(a)(8), 1328(a).
7. 11 U.S.C. § 523(a)(8); see also *Student Aid Funds, Inc. v. Espinosa*, 130 Sup. Ct. 1367, 1375 (2010).
8. *Espinosa*, 130 Sup. Ct. at 1375.

v. New York State Higher Education Services Corp.,[9] a second circuit case from the late 1980s that's been followed strictly or in modified form in various courts across the country for nearly three decades.

In the seventh circuit, the undue hardship test is gentler, as demonstrated by the fact that the able-bodied, well-educated borrower with no dependents in *Krieger* qualified for a discharge.

The undue hardship test is a case-specific, fact-dominated standard. Under *Brunner*, the three elements a student borrower who seeks a loan discharge must demonstrate are that: (1) he can't maintain a minimal standard of living for himself and his dependents if forced to repay the loans; (2) additional circumstances indicate that the hardship is likely to persist for a significant portion of the repayment period (the so-called "persistence" element); and (3) he has made good faith efforts to repay the loans.[10]

In jurisdictions that follow *Brunner*, the "additional circumstances" factor (element "2" above) equates to a "certainty of hopelessness."[11] That is, a debtor must show the court that his fiscal straits are dire and will likely stay that way.

The seventh circuit's *Krieger*: A relaxed, "common sense" test

The seventh circuit paid lip service to *Brunner* but applied a more flexible, fact-specific test in *Krieger v. Educational Credit Management Corp.*[12] There, the seventh circuit reversed the district court and reinstated the bankruptcy court's discharge of about $25,000 of the debtor's student loan debt. The *Krieger* debtor was in her early 50s, divorced, hadn't worked in over two decades, and took care of her elderly mother. The debtor also lived in a rural area where jobs were scarce and she lacked reliable transportation.

The seventh circuit found that the borrower met *Brunner's* three-part undue hardship test: she was destitute, hadn't worked in over two decades and was "out of the money economy" (element one).[13] The court also pointed out that the borrower lacked transportation to move to an area with brighter prospects and that her circumstances were likely to persist and not improve (element two).

As for element three of the *Brunner* test – good faith – *Krieger* didn't analyze this factor. Instead, the court held that good faith is highly fact-dominated and requires clear error for reversal. And since the bankruptcy judge's good faith determination, based on some 200 job applications the debtor submitted over the years, wasn't clearly erroneous, it should have been upheld.

Krieger is also notable for its concurrence. In it, Judge Manion observes that the debtor is physically healthy, intelligent, and graduated from paralegal school with a high GPA. He didn't think the debtor's circumstances were egregious enough to merit a discharge and questioned whether other student borrowers will use this case as an "excuse to avoid their own student loan obligations?"[14] He pointed out that applying for 200 jobs over a 10-year period amounted to less than two applications per month – hardly a robust job search effort.

Krieger's more flexible undue hardship test tempers the harshness of *Brunner's* "certainty of hopelessness/persistence" standards and was recently endorsed by the Western District of Wisconsin in a case involving a quadriplegic debtor who had about $14,000 in student loan debt discharged even though he was working full time and making about $30,000 per year.[15]

The court lauded *Krieger* for injecting "common sense" and a "refreshing" perspective into the student loan discharge question[16] and backed up its support of *Krieger* with statistics. The court found that a relaxed undue hardship standard was especially warranted in view of the

9. *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395, 396 (2d Cir. 1987).
10. *Krieger v. Educational Credit Management Corp.*, 713 F.3d 882, 883 (7th Cir. 2013).
11. See, *e.g.*, *In re Frushour*, 433 F.3d 393, 401 (4th Cir. 2005).
12. *Krieger*, 713 F.3d at 882.
13. *Id.* at 884.
14. *Id.*
15. *In re Myhre*, 503 B.R. 698, 702 (W.D. Wisc. 2013).
16. *Id.*

Favorable Factors for Getting Student Loans Discharged

- ☑ You have physical or mental ailments
- ☑ Your income is dwarfed by your loan
- ☑ You have dependents
- ☑ Your work experience or degree isn't likely to increase your earning power
- ☑ You kept in contact with your lender
- ☑ You tried to make payments
- ☑ Your jurisdiction applies the totality-of-circumstances test (as opposed to *Brunner's* three-part undue hardship test)

recent years' explosion in student loan availability coupled with the lockstep expansion of student loan default and discharge attempts.

Yet, even for its gushing approval of *Krieger*, the facts in *Myhre* are still relatively extreme. The debtor was physically disabled and required around-the-clock care. As a result, *Myhre* may have limited precedential value for cases involving borrowers that are physically healthy and gainfully employed.

The 'totality of circumstances' test

The eighth circuit applies what it labels a "rigorous," multi-factored "totality of circumstances" test when weighing whether a student loan debtor meets the test for undue hardship and discharge.[17] Under this test, the court considers: (1) the debtor's past, present, and reasonably reliable future financial resources; (2) a calculation of the reasonable living expenses of the debtor and her dependents; and (3) any other relevant facts and circumstances surrounding the particular bankruptcy case.[18]

For the third element, the eight circuit bankruptcy courts drill down further and analyze additional factors including: (1) the debtor's total present and future incapacity to pay debts for reasons not within his control; (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) the permanent or long-term disability of the debtor; (6) the ability of the debtor to obtain gainful employment in the area of study; (7) the debtor's good faith effort to maximize income and minimize expenses; (8) whether the dominant purpose of the bankruptcy petition was to discharge the student loans; and (9) the ratio of student loan debt to total indebtedness.[19]

Other jurisdictions and recent cases

A survey of court decisions at the bankruptcy, district, and appellate levels reveals a mixed bag of the factors a court will apply in its undue hardship calculus.

While the ninth circuit follows *Brunner*,[20] a Montana district court still found that the debtor satisfied the difficult test earlier this year in *In re Jolie*.[21] There, the court discharged the debtor-borrower from about $150,000 in student loans. Finding that the debtor was not required to live in abject poverty, the court's decisive factors included that the debtor made only $26,000 a year, had myriad physical ailments, and had made only a single $1,600 payment in the past six years.

The first circuit rejected *Brunner* and adopted the totality of circumstances test in *In re Bronsdon*.[22] The Court there affirmed the Massachusetts bankruptcy court's undue hardship finding, noting that the 64 year-old debtor who failed

17. *Walker v. Sallie Mae Servicing Corp.*, 650 F.3d 1227, 1230 (8th Cir. 2011).
18. *Id.*
19. *In re Bakken*, 2014 WL 293809, *9-10.
20. *Hedlund v. Educational Resources Institute*, 718 F.3d 848 (9th Cir. 2013).
21. *In re Jolie*, 2014 WL 929703 (Bankr. D. Mont. 2014).
22. *In re Bronsdon*, 435 B.R. 791 (1st Cir. 2010).

three bar exams and lived on a fixed income of less than $1,000 per month would be unable to pay over $80,000 in student loans. The court refused to find the borrower failed to show good faith by not enrolling in an Income Contingent Repayment Plan (ICRP) offered by the lender. The court noted that an ICRP plan can often have a negative impact on a borrower since it usually results in negative amortization, increased interest charges, and a tax burden for the borrower.

The fourth circuit strictly followed *Brunner* and denied a borrower's discharge bid in *In re Frushour*.[23] Reversing the South Carolina district court, the *Frushour* court held that the borrower, a 47-year-old whose loan debt totaled just over $12,000, failed to meet the additional circumstances and good faith components of the undue hardship test.

Applying a hybrid standard of review because undue hardship is a mixed question of law and fact, the court reversed, focusing on the borrower's failure to show exceptional circumstances beyond her present inability to pay coupled with her failure to avail herself of a loan consolidation plan offered by the lender. On this latter point, the court decried the borrower's failure to exert the "requisite effort" to repay the loans.[24] The court also found the borrower's hopes for a financial "fresh start" showed a "lack of interest" in repaying her loans.[25]

In re Gerhardt represents the fifth circuit's application of the *Brunner* test.[26] There, the court affirmed the district court's denial of the debtor's attempt to discharge nearly $80,000 in student loan debt. The court held that the debtor failed to establish persistent undue hardship – the second *Brunner* element – and noted that no factors beyond the debtor's control exist to perpetuate the debtor's inability to make payments. Noting that a student debtor wasn't required to find work in his chosen field, the court held that if it allowed the claimed discharge here, it would be hard to imagine any similarly situated debtor that *would not* qualify for a discharge.

For summaries of these and other recent student loan discharge cases, visit www.isba.org/ibj/2014/11/studentloancases.

Partial discharge – the wave of the future?

If you have a case that doesn't fit the *Brunner* or totality-of-circumstances framework, note that at least one case has allowed a partial discharge. In *In re Fecek*,[27] the debtor was an employed nurse with no dependents who made about $53,000 per year. The court cited evidence that demonstrated that the most the debtor could expect to earn in her lifetime was about $70,000 per year.

The Indiana bankruptcy court found undue hardship. But it distinguished between undue hardship at one end of the continuum and a "major personal or financial sacrifice" at the other. The court held that while the debtor satisfied all three *Brunner* elements, she should still have to pay something back in light of her income, health, and lack of dependents. The court reduced her payment from about $2,600 per month to about $450.[28] According to the opinion, this "partial discharge" allows a court to "reach a more equitable result, tailored to a debtor's specific financial situation."[29]

Which student-loan debtors are winning discharge?

As the student loan debt problem becomes acute and the lawyer glut continues to grow, the student loan discharge question begs for resolution.

Many of the student loan discharge fact patterns are depressing. The personal and financial circumstances faced by the borrowers in the cases range from inconvenience to abject poverty. Like so many other legal tests, whether a given borrower qualifies for a discharge is a fact-specific inquiry.

Linking strands among pro-borrower cases (that is, those where a discharge was granted) include physical or mental ailments, income dwarfed by the loan amount, dependents, and work experience or degree that isn't likely to increase earning power. Conversely, and perhaps obviously, the typical debtor in cases where a discharge was refused is physically and mentally healthy, has no dependents, and is well-educated.

From the cases, it's also clear that a borrower who has kept in contact with the lender and at least tried to make some payments has a better chance of showing good faith – element "3" of the *Brunner* hardship test – and therefore obtaining a discharge.

While most jurisdictions follow some variant of *Brunner*, others apply a more relaxed totality-of-circumstances test that doesn't require a certainty of hopelessness or persistence of a distressed economic condition. All other things being equal, whether you win a discharge depends largely on whether your jurisdiction applies the three-part *Brunner* rule or the more flexible totality test.

In the seventh circuit, the three-part undue hardship test is gentler than Brunner's – as demonstrated by the fact that the able-bodied, well-educated borrower with no dependents in *Krieger* still qualified for a discharge. It remains to be seen whether *Krieger's* flexible undue hardship test will result in more student loan discharges over the ensuing years. ■

23. *In re Frushour*, 433 F.3d 393 (4th Cir. 2005).
24. *Id.* at 402.
25. *Id.*
26. *In re Gerhardt*, 348 F.3d 89 (5th Cir. 2003)
27. *In re Fecek*, 2014 WL 1329414 (Bankr. S.D. Ind. 2014).
28. *Id.* at *9.
29. *Id.*