

DISCHARGING STUDENT LOANS IN BANKRUPTCY: GOOD LUCK WITH THAT

Michael Forrest, University of the Incarnate Word
Joseph Labatt, University of the Incarnate Word
Robert Swartz, San Antonio

CASE DESCRIPTION

This case speaks to the real financial fears resulting from burdensome student loan debt experienced by millions of students upon leaving college. Unlike other types of debt obligations held by creditors, student loan debt falls into a special category and is not readily dischargeable in bankruptcy, absent proof of “undue hardship” that precludes paying back the loans. The major topics of the case are bankruptcy, consumer protection, legal environment of business, and ethics. Given the applicability of the topic to students who will soon be obligated to make student loan payments, the case is appropriate for students in a business law class that covers bankruptcy. The case is designed to be taught in one class period, with the expectation that students will have spent two hours in preparation outside of the classroom.

CASE SYNOPSIS

In his 2016 State of the Union address, President Barack Obama argued that “We have to make college affordable for every American. No hardworking student should be stuck in the red.” Indeed, “stuck in the red” is an all too common condition for American students. Outstanding student debt in the United States, by some estimates, stands at \$1.2 trillion, held by borrowers numbering in the tens of millions. For these debtors, what began as an optimistic investment in higher education has turned to deep disillusionment and a sense of betrayal. High paying jobs students counted on too often fail to materialize. Instead, college graduates are caught in a perpetual struggle to manage high loan payments. What follows is a story of one such student.

The case chronicles the vicissitudes of Rory Grette, who borrowed money to pay for a prestigious undergraduate degree and graduate school that he did not finish. A family crisis, economic downturn, lost job, consumer debts, and unexpected medical bills left Rory in financial straits. He seeks to discharge his student loans and other debts in bankruptcy. The question is whether the required payment of his student debt constitutes an “undue hardship.”

CASE BODY

The Facts

Middle class parents in a mid-sized town in the Midwest raised Rory Grette. Their dream was for him to go to college and maybe even get his M.B.A. someday. Rory was an excellent student. He had no trouble being admitted to a nearby state university. Rory had bigger dreams, however. He studied intensely for the SAT test, scored high, and chose an elite Eastern college over the hometown state school. Rory’s parents explained that had he chosen the local option he

could have lived at home, paid lower tuition, and earned a degree with little or no student loans hanging around his neck. Instead, Rory graduated in the middle of his class from “Ivy U” with \$150,000 in student loan debt, but kept his eye on the prize of owning a successful business someday. Apprehensive but undeterred by his financial obligations to a faceless “State Higher Education Financial Services Corporation” (at least that was what was printed on student loan payback notices), Rory vowed to continue his education by returning home to get an M.B.A. at the state school. “Defer and pay” was his mantra. More student loans paid for graduate school tuition, which seemed high to Rory even though he got the in-state rate.

While in graduate school, Rory quit his studies to help his parents who had suffered financial and health setbacks. His outstanding student loans then totaled \$175,000, for which he had to show a B.A. in Economics and one-half an M.B.A. (not a degree at all).

Economic times in Rory’s area of the county were dire. Manufacturing plants had been closing steadily because of foreign competition and high labor and legacy costs under contracts made with unions struck in better times. Not to mention 40,000 pages of new government regulations added by the administration, which increased the cost of business. Rory’s parents were casualties of the downturn. They were both laid off from jobs long held. Neither had the will to continue looking for meaningful work, which led to the couple experiencing despair and depression. Determined to keep the family afloat, Rory took a job as a strategic planner with a defense manufacturer, even though the idea of working for the “military industrial complex” violated all of the ideals with which he had been inculcated in college. Nonetheless, his pay was more than enough to maintain his parents’ household and make regular payments on his student loans. Twelve months; twelve \$500 loan payments dutifully posted.

Things were sailing on an even keel until the federal budget was sequestered and the administration cut the allocations for defense. Rory lost his job, his steady income, and his health insurance. He networked, searched, and applied for any job that might come his way, but his efforts to find employment were for naught. Even when he would get a nibble on a job lead, potential employers shied away because his Ivy League pedigree made him appear to be overqualified—if not desperate.

At wit’s end, Rory signed up to drive for Uber. This required that he get a late model car. He found a one-year-old Mazda that fit the bill and paid for it with a high-interest car loan in the amount of \$15,000 at 5% interest. All earnings went to pay down the car loan; he stopped all student loan payments. Dunning letters from the State Higher Education Financial Services Center went into the trash. Gas, food, and rent were the priorities for his family.

One day while sitting in his car hoping to catch a fare, Rory had a revelation sparked by a YouTube video he watched on his iPad. The speaker encouraged listeners to look beyond their own circumstances and find ways to help people without resources improve their lives. Rory realized he was too caught up in his own misery over financial pressures and decided it was his mission to help denizens of the inner-city take control through sustainable initiatives. He immediately drove to the nearest church and walked up to the padre, who spoke in broken English. Rory pitched the idea of a community garden—small-plot gardening as a means to give people the skills to grow their own food, improve their diet, and make a contribution, however paltry, to the fight against world-wide famine and the scourge of global warming. This idea was fostered by discussions in an Economics class that followed a viewing of “An Inconvenient Truth.” Rory was a new man. Even though his dreams of being a corporate giant were long ago extinguished, he reveled in his newfound mission to serve mankind and Mother Nature. He maxed out his available credit on two cards buying tools, bags of organic fertilizer and seedling

trays full of vegetable sprouts. On an especially pleasant day, in the middle of demonstrating hoeing techniques at a planting clinic at the church, Rory suffered a minor injury to his foot. Just a scratch, really. A rambunctious youth had grabbed a three-pronged cultivator. While stabbing at the ground, he nicked Rory's foot, through the boot. The skin was barely broken. Thankfully his tetanus shot and booster were still current. A week later, Rory was in the emergency room. His foot was terribly swollen with the poison from the infection already up to the knee. That is where the doctors cut—at the knee. Rory was in the hospital for six weeks. His obligations on the medical bills (for deductibles, a prosthetic device, and rehabilitation) totaled \$30,000.

During his absence, the “mankind and Mother Nature” program (as it was called) collapsed. Most recruits found it was a whole lot of bother for not much bounty. Instead of hoeing, planting, fertilizing, watering, and fighting insects, it was easier to go to the corner market to take advantage of government food stamps. The final straw was an early freeze that killed most of the plants.

Fortunately, Rory's injury did not preclude his profession as an Uber driver. He has returned to picking up fares and brings in on average \$2,000 a month. This amount barely pays for household expenses. He still resides with his aging parents, who are on Social Security. Rory receives demand letters from his creditors almost daily. Bankruptcy may be Rory's best option for a chance to discharge his debts and get a fresh start.

The Bankruptcy Proceeding

Rory filed his petition for bankruptcy relief under Chapter 7 of the United States Bankruptcy Code. He seeks to discharge debts that are primarily consumer debts, defined in 11 U.S.C. § 101(8) as "incurred by an individual primarily for a personal, family, or household purpose." Notably, the Bankruptcy Code at 11 U.S.C. § 523(a)(8)(B) also provides that educational loans can only be discharged if payment “would impose an undue hardship on the debtor and the debtor's dependents.”

The schedule of Rory's assets and liabilities is as follows:

Name of Schedule	Assets	Liabilities	Other
Real Property	\$0		
Personal Property	\$10,000		
Secured Claims (Car)		\$15,000	
Unsecured Claim (Student Loans)		\$173,000 (loan payments made largely went to interest)	
Unsecured Claim (Credit Cards)		\$12,000	
Unsecured Claim (Medical Bills)		\$30,000	
Current Income (Monthly)			\$2,000
Current Expenditures (Monthly)			\$2,700
Total	\$10,000	\$230,000	

While waiting for fares, Rory researched the Internet for solutions to his financial dilemmas. He found a story about Mark Tetzlaff. Tetzlaff was unsuccessful in discharging his student loan debt of over \$250,000. The case made national news when the United States Supreme Court declined to hear his case, which challenged the circuit court ruling that his financial and personal hardships were insufficient reasons to have his massive loan debt discharged in bankruptcy.

Rory learned from his research that different bankruptcy courts apply various legal tests in determining whether student loans can be discharged in the case of an undue hardship. These inconsistencies, called a “split in the circuits,” mean that the different tests used by the various federal courts produce varied results that affect student interests. What are the three Circuit Court tests and when applied to Rory’s facts, what would be the likely outcome under each test? What policy changes—such as limiting loan amounts, restructuring repayment options, and/or easing loan forgiveness rules—could be made by Congress to bring more certainty to the issues of managing excessive student loan debt?

Here are the results of Rory’s research:

News Stories

Kendall, Brent and Josh Mitchell (2016). Supreme Court denies appeal on student-loan erasure. *Wall Street Journal*. Retrieved February 11, 2016, from <http://www.wsj.com/articles/supreme-court-denies-appeal-on-student-loan-erasure-1452527286>

[Powell, Farran \(January 31, 2017\). 3 student loan reforms to expect under Trump. *U.S. News & World Report*. Retrieved March 15, 2017 from https://www.usnews.com/education/best-colleges/paying-for-college/articles/2017-01-31/3-student-loan-reforms-to-expect-under-trump](https://www.usnews.com/education/best-colleges/paying-for-college/articles/2017-01-31/3-student-loan-reforms-to-expect-under-trump)

The case that prompted the (2016). *Wall Street Journal* story is *Tetzlaff v. Educational Credit Management Corp.*, 794 F.3d 756 (7th Cir. 2015), *cert. denied*, 2016 U.S. Lexis 61 (2016).

Scholarly Articles

Gubbiotti, Carmelia (2015). Student loans can be discharged (at least partially) in bankruptcy after all. 7 St. John’s Bankr. Research Libr. No. 12. Retrieved February 16, 2016, from http://www.stjohns.edu/sites/default/files/documents/law/bankruptcy/2015-12-gubbiotti_carmella.pdf

Taylor, Aaron N. & Sheffner, Daniel J. (2016). Oh, what a relief it (sometimes) is: An analysis of Chapter 7 bankruptcy petitions to discharge student loans. 27 *Stan. L. & Pol’y Rev.* 295.

Wallen, Ben. (2016). One standard to rule them all: An argument for consistency in education debt discharge in bankruptcy proceedings. 19 *Hous. Bus. & Tax L.J.* 232.