DISCHARGING STUDENT LOANS IN BANKRUPTCY: GOOD LUCK WITH THAT

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INSTRUCTORS' NOTES

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."

RECOMMENDATIONS FOR TEACHING APPROACHES

This case should be introduced with a basic introduction into how federal bankruptcy operates to liquidate debt, albeit not all types of debt. The case examines the specific category of student loan debt and the limited remedies available for its discharge under bankruptcy. First, students should understand the goals of bankruptcy, who benefits from the process, and why certain categories of debt, such as student loans, receive less favorable treatment for the debtor. Turning from the general to specific, students can explore news accounts and/or primary court opinions in the matter of *Tetzlaff v. Education Credit Management Corporation*, a case that inspired the creation of this case study. *Tetzlaff* was litigated in the federal courts at the trial and appellate levels, with published opinions in 2014 and 2015, respectfully. The United States Supreme Court, in January 2016, denied review of the issue of whether student loans can be discharged in bankruptcy, leaving some uncertainty in the law because different intermediate courts have provided varied approaches in assessing student debtors' financial hardships. As with most legal issues, the legal test applied to the facts determines the outcome. What is the predictable legal consequence from the application of each of the three tests? Should the United States Supreme Court, if presented with this issue in the future, settle the split in the circuits and bring more certainty to the issues of discharging student loan debt in bankruptcy?

BACKGROUND OF THE LAW

Bankruptcy Law 101: Providing a Fresh Start for the Debtor

"The law of bankruptcy provides possible solutions to problems that arise when a person . . . is unable, or finds it difficult, to satisfy obligations to creditors" (Morgan, 2015, p. 820). Put plainly, bankruptcy gives a debtor the chance to start over, either by restructuring debt or liquidating it. The two federal laws controlling the process are the Bankruptcy Reform Act of 1978 and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. These statutes set up three avenues to dispose of debt. Under Chapter 13 of the Bankruptcy code, the debtor works under the supervision of a trustee to create a payment plan that reduces the amount of debt to a feasible amount that can be paid off under a payment plan extended over three to five years (Morgan, 2015, p. 828). Typical Chapter 13 plans apply to debtors with unanticipated large medical bills, out of control credit card balances, and other consumer debt.

Chapter 11 bankruptcy provides for a reorganization of debt such that creditors are paid over an extended period, based on a plan formulated in consultation with a committee of one's creditor (Morgan, 2015, p. 825). Rather than addressing consumer debt, Chapter 11 is usually applicable to businesses and rich people wanting to restructure their obligations to creditors.

Chapter 7 bankruptcy liquidates the debtor's obligations to creditors (Morgan, 2015, p. 825). Debts that are included in a Chapter 7 proceeding are satisfied in whole or part by a trustee who takes control of the debtor's assets, such as houses, cars, bank accounts, and personal possessions. The trustee then sets aside for the debtor certain items "exempt" from bankruptcy, such as the house with a homestead exemption, one car per driver in the family, furniture, clothing, and tools of one's trade. The remaining assets are divided among the creditors, with the class of secured creditors (those who took collateral in the loan) paid first, and the class of unsecured creditors (such as credit card companies) paid last. If the assets are not sufficient to satisfy all of the obligations of the class, the creditors take a pro rata share of the assets. In practice, this could leave the class of secured creditors receiving pennies on the dollar for the credit they extended, and the class of unsecured creditors with no satisfaction. The debtor, however, is debt free following the bankruptcy.

What complicates a Chapter 7 bankruptcy that is pertinent to this case study is certain categories of debt cannot be discharged in bankruptcy. Title 11, section 523(a)(8)(B) of the United States Code provides:

(a) A discharge under . . . 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__. . .
(B) any other educational loan . . . incurred by a debtor who is an individual . . . .

This provision proscribes discharge of student loans except where requiring payment would constitute an undue hardship. Courts in different jurisdictions of the country have interpreted and applied "undue hardship" in three different ways. This has led to a "split in the circuits" (a term of art for when two or more appellate courts rule differently on the same legal issue). Oftentimes, when there is a circuit split, the U.S. Supreme Court takes up the issue on a petition for *certiorari* to settle the matter. The High Court had such an opportunity with *Tetzlaff* and declined. Thus, an air of uncertainty clouds this area of the law.

An instructive article by Gubbiotti (2015) outlines the split in the circuits over discharge of student loans in bankruptcy.

1. The Totality of the Circumstances Test

The totality of the circumstances test is applied in the Eighth Circuit. There are 13 judicial circuits. The Eighth comprises federal courts in the following states: Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. The controlling law in federal courts sitting in this Midwestern region is *Long v. Educational Credit Management Corporation (In re Long)*, 322 F.3d 549 (8th Cir. 2003). Long was a chiropractor who financed her education with student loans. She practiced for several years but had to quit because of extreme fatigue, depression and declining mental capacity. The bankruptcy court found that her mental condition was persistent and interfered with her earning potential. Long moved in with her parents, took a job unrelated to her training as a chiropractor, and spent the bulk of her earnings on household expenses and community college classes in a new field of study. Fortunately for Ms. Long, the bankruptcy court granted her an undue hardship discharge so that she would not be "sentenced" to 25 years of payments on a debt she would not likely retire or reduce. (*In re Long*, 2003.)

In evaluating the totality-of-the-circumstances, courts in the Eighth Circuit considers:

(1) The debtor's past, present, and reasonably reliable future financial resources;

(2) A calculation of the debtor's and her dependent's reasonable necessary living expenses; and

(3) Any other relevant facts and circumstances surrounding each particular bankruptcy case. (*In re Long*, 2003, p. 554.)

What this boils down to is whether the debtor's future financial prospects will produce enough money to pay down student loans and in addition to cover expenses required to maintain a minimal standard of living. While the *Long* court was focused on establishing the guiding law in that case, and made no specific findings on Ms. Long's circumstances, the opinion indicates that she should not be expected to pay back loans on her training to be a chiropractor when her physical and mental states precluded her from making a living in that profession. (Gubbiotti, 2015.)

2. The *Johnson* Test

The case of *In re Johnson*, 5 Bankr. Ct. Dec. 532 (Bankr. E.D. Pa 1979), came out of Pennsylvania, which is in the Third Circuit, comprising federal courts sitting in Delaware, New Jersey, Pennsylvania, and the Virgin Islands. It sets forth a three-pronged test to determine undue hardship. First, can the debtor maintain at least a subsistence level of living over the lifetime of the loan if making regular payments? If so, there is no undue hardship. Second, was the debtor careless in efforts to maximize income and minimize expenses—and if so, would more responsible financial management have affected prospects of paying down the loan? In such case, the debtor has not acted in good faith and should not have the loan discharged. Third, is the bulk of the debt the debtor seeks to discharge from the student loan (or is the loan just part of greater non-student-loan categories of debt), or has the debtor benefitted financially from the education that was financed by loans? (Gubbiotti, 2015.) The court will make a policy judgment on whether the debtor benefitted financially from the education. A petitioner can prevail on a claim of undue hardship by satisfying any one of the prongs of the test.

Ms. Johnson, the petitioner in the case, had her student loans discharged because her student loan debt was less than 30% of her overall indebtedness and she did not benefit financially from the education for which she took out loans; she did not complete even one year of college classes (*In re Johnson*, 1979, p. 57-58). While Johnson received relief from her bankruptcy proceedings, the three-part inquiry used by the court to assess undue hardship is a somewhat complicated analysis that lacks a bright line to guide consistent results. Because of its subjectivity in application, many courts have rejected the *Johnson* approach (Frattini, 2001, p. 555).

3. The *Brunner* Test

The Seventh Circuit follows the case of *Brunner v. New York State Higher Education Services Corporation*, 831 F.2d 395 (2d Cir. 1987). Federal courts in the Second Circuit sit in Connecticut, New York, and Vermont. *Brunner* is considered the majority approach to the undue hardship analysis (Sparrow, 2007, p. 332). The *Brunner* test also has a three-part analysis the debtor must satisfy to prove undue hardship:

> (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 (*Brunner*, 1987, p. 396).

All three elements must be proved to merit having the student loan discharged (Gubbiotti, 2015). The *Brunner* court noted that debtors may have difficulty in proving undue hardship because part of the test requires looking into the future to prove that current inability to make loan payments will extend throughout much of the loan period. Because Ms. Brunner was not disabled, elderly, or responsible for the care of dependents, her future job prospects were on the positive side, particularly in light of the fact that she had a master's degree. Moreover, the court found a lack of good faith on her part based on her filing for bankruptcy in the month that her first payment on the loan was due.

In summary, Gubbiotti (2015) offers a quick review of the various legal tests just discussed. For an in-depth legal analysis of the issue, Frattini (2001) gives a scholarly treatment of bankruptcy law history, the tests for undue hardships, and explication on a wide range of case law.

DISCUSSION QUESTIONS

Application Based on the Totality of the Circumstances Test

1. What are the debtor's past, present, and future resources?
    Pro discharge in bankruptcy: Family obligations to take care of parents; lifestyle choice to serve others does not pay well.
    Con: Economic downturns turn around; debtor has chosen mission work and unstable employment.
2. Can the debtor meet reasonable living expenses?
    Pro discharge in bankruptcy: Monthly expenses exceed monthly income.
    Con: Has unstructured income as an Uber driver.
3. Any other relevant facts?
    Pro discharge in bankruptcy: Disabled. Liabilities greatly exceed assets.
    Con: Has higher earning potential with prestigious degree in Economics.

Application Based on the *Johnson* Test (affirmative on any one of the questions will show an undue hardship)

1. Can the debtor make student loan payments and still subsist?
    Pro discharge in bankruptcy: Monthly expenses exceed monthly income.
    Con: Has higher earning potential with prestigious degree in Economics; has unstructured income as an Uber driver.
2. Has the debtor maximized income and minimized expenses?
    Pro discharge in bankruptcy: Unable to get better job due to economic downturn; financed a reasonably modest car.
    Con: Could have gone to nearby state school and lived at home; would not need car loan if Uber position not chosen.
3. Is the greater percentage of the indebtedness from student loans?
    Con: 2/3 of debt is in student loans.

Application Based on the *Brunner* Test (affirmative needed on all three to show an undue hardship)

1. Can the debtor make student loan payments and still subsist?
    Pro discharge in bankruptcy: Monthly expenses exceed monthly income.
    Con: Has higher earning potential with prestigious degree in Economics; has unstructured income as an Uber driver.
2. Will the current financial hardship continue into the future?
    Pro discharge in bankruptcy: Yes, if he continues with Uber position and mission work.
    Con: Economic downturns turn around; debtor has chosen mission work and unstable employment.
3. Has the debtor made a good faith effort to pay back the student loans?
    Pro discharge in bankruptcy: Paid loans for one year when had steady employment
    Con: No payments made while in Uber position.

QUESTIONS FOR REFLECTION

With the prospects of a change in justices at the Supreme Court, what should the Court do in the future should it again have the opportunity to settle the split in the circuits with regard to the discharge of student loan debt in bankruptcy?

Are there legislative or executive actions that could be taken to offer people overburdened by student loan debt relief in bankruptcy?

What could people incurring massive student loan debt due to reduce the possibility of undue hardship when it comes time to service the loan debt?

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