

Student Loans: Bankruptcy and Beyond

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1. Student loans in bankruptcy - How are student loans affected by Chapter 7 and Chapter 13 bankruptcy proceedings?
 - a. Automatic stay. The automatic stay applies to student loan creditors in both Chapter 7 and Chapter 13 contexts. Student loan creditors may resume all collection efforts after the stay terminates.
 - i. The automatic stay will prevent a federal student loan creditor from initiating or continuing an administrative wage garnishment.
 - ii. Colleges and universities cannot withhold transcripts on the basis of unpaid pre-petition tuition for fees without violating the automatic stay.
 - iii. A student loan creditor may condition the availability of new student loans on the payment of pre-petition student loans and not violate the automatic stay. See *Moss v. Sallie Mae, Inc.*, 2012 Bankr. LEXIS 1693 (April 2012).
 - b. 523(a)(8). The discharge of student loan debt is limited by §523(a)(8).
 - i. Exceptions to discharge in 523(a)(8):
 - (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution;
 - (A)(ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
 - (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual.
 - ii. This exception to discharge applies to all federal and private student loans.
 - c. Undue hardship. Consumer debtors can discharge federal and private student loans debt if they can establish “**undue hardship**.” Generally, this means that a debtor’s present income is inadequate to pay the loan, and that this situation is unlikely to change even after considering the debtor’s future earning potential.
 - i. The 7th Circuit has adopted the three-prong Brunner test for establishing undue hardship. *Brunner v. New York State Higher Educ. Serv. Corp.*, 831 F.2d 395 (2d Cir. 1987). The three part test is as follows:
 1. The debtor cannot maintain, based on current income and expenses, a minimal standard of living for the debtor and the debtor’s dependents if forced to repay the student loans.
 2. 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.
 - a. This has been referred to as the “certainty of hopelessness test.”

3. The debtor has made good faith efforts to repay the loans.
- ii. Courts decide whether “undue hardship” exists. Generally, ordinary or garden-variety hardship is insufficient.
- iii. Debtors should bring an adversary proceeding seeking a declaratory judgment that a particular debt is dischargeable.

2. Student loans and Chapter 13.

- a. Default treatment of student loans in Chapter 13 plans.
 - i. By default, student loans, both federal and private, are treated as general unsecured non-priority debts in Chapter 13 plans.
 - ii. The proposed distribution to general unsecured creditors will dictate what payments student loan creditors receive during the course of a Chapter 13 plan.
 - iii. If student loan creditors are paid less than what is contractually due during the course of a plan, a debtor could enter default status (discussed below) and be subject to default interest rates and other negative ramifications once plan is complete.
- b. Separate classification. Chapter 13 debtors can, in certain scenarios, propose to separately classify their student loan creditors from their other general unsecured creditors.
 - i. Once separately classified, a Chapter 13 debtor can propose to remain current on student loan debts by maintaining their contractual payments directly to their student loan creditors over the course of the Chapter 13 plan.
 - ii. The statutory basis for separate classification is 11 U.S.C. §1322(b)(5), which provides that a debtor may maintain payments on any unsecured claim on which the last payment is due after the due date of the final plan payment.
 - iii. However, 11 U.S.C. §1322(b)(5) seems to conflict with 11 U.S.C. §1322(b)(1), which provides that, while a debtor may designate a class of unsecured claims, that debtor may not discriminate unfairly against any class so designated.
 - iv. Local cases: *In re Truss*, 404 B.R. 329 (April 2009), *In re Johnson*, 446 B.R. 921 (March 2011), *In re Edmonds*, 2010 Bankr. LEXIS 3944 (Bankr. E.D. Wis. Nov. 5, 2010).
 - v. By default, the Department of Education will take a student loan out of repayment status once it received notice of a bankruptcy filing. If your debtor is proposing to separately classify student loan debt and maintain normal payments directly to the student loan creditor, is it imperative that a phone call be placed to the Department of Education to ensure that the loans are returned to repayment status.

3. Student loans outside bankruptcy. If a debtor cannot discharge student loans in bankruptcy, what non-bankruptcy options do they have to deal with the loans?

- a. Federal Loans v. Private loans. First, let's take a closer look at federal and private loans.
 - i. Key difference between federal loans and private loans: creditor remedies.
 - ii. Private loans:
 - 1. Statutes of limitation apply to private loans
 - 2. Private loans can only be enforced through judicial mechanisms under state law.
 - 3. Essentially, a private loan creditor has the same collection options as a credit card creditor.
 - 4. There is no *administrative garnishment* for private loans.
 - iii. Federal loans:
 - 1. Backed by the U.S. Government. In the event of default, the loans go back to the Department of Education.
 - 2. Multiple parties involved:
 - a. Department of Education
 - b. Guarantors (FDCPA does not apply to guarantors)
 - c. Private banks
 - d. Servicers - Responsibility for servicing the loan when it is in **good standing**. (FDCPA does not apply to servicers)
 - e. Third party debt collectors - Loans **not in good standing** go here. FDCPA applies to third party debt collectors.
 - 3. Types of federal student loans:
 - a. *Stafford Loans*. Federal loans offered to eligible student enrolled in accredited American institutions of higher education to help finance their education.
 - i. These loans are very common.
 - ii. Subsidized stafford loans - need-based.
 - iii. Unsubsidized stafford loans - not need-based.
 - b. *Parent Plus Loans*. Federal loans offered to parents of students enrolled in eligible post-secondary institutions in eligible programs.
 - c. *Graduate Plus Loans*. Federal loans offered to graduate and professional students.
 - d. *Federal Perkins Loans*. Need-based federal student loan offered by the US Department of Education, originated by schools themselves.
 - 4. The National Student Loan Data System (NSLDS) is a great resource to ascertain the full extent of your client's federal student loan obligations. <http://www.nslds.ed.gov/>
- b. Administrative (Statutory) Discharge. Certain specific factual scenarios can trigger administrative discharge for federal student loans (NOT private loans).
 - i. *School Closure*. 20 U.S.C. §1087(c)(1). Most common administrative discharge. This can apply when the academic institution the debtor is attending closes during the course of the debtor's attendance.

- ii. *Disability.* 20 U.S.C. §1087(a). This can apply in the event that the debtor becomes totally and permanently disabled and is not able to be employed in any capacity.
 - iii. *Unpaid Tuition Refund.* 20 U.S.C. §1087(c). This can apply when an institution wrongfully pursues a student who withdrew from attendance within the required time frames and within the proper guidelines.
 - iv. *False Certification.* 20 U.S.C. §1087(c)(1). This can apply in the event that a school falsely certified that a particular student is eligible for student loans.
- c. Statutes of federal student loans.
 - i. *In-school Deferment.* While in school, a student can defer federal loans provided they remain enrolled on at least a part-time basis.
 - ii. *Repayment.* When students are no longer attending school at least-part-time, they receive a six month grace period before entering repayment.
 - iii. *Other Deferments.* Deferment is possible in the event of unemployment or economic hardship. However, unemployment or economic hardship deferment is limited to 36 months over the total life of the loan. Deferment may also be possible for individuals in active duty service for the armed forces.
 - iv. *Delinquency.* A debtor is delinquent if they are 1 to 270 days late on a payment. Delinquent debtors have not yet entered default status.
 - v. *Default.* A debtor enters default when they fall more than 270 days behind in payments.
- d. Consequences of default.
 - i. Once in default, federal student loans will transfer to third party debt collectors. Debtors can expect collection letters and phone calls.
 - ii. Default interest rates can be very high.
 - iii. Income tax refunds can be intercepted.
 - iv. Social Security Disability payments can be offset.
 - v. Administrative wage garnishments can commence after a thirty day warning letter is sent to the debtor. These garnishments do not require a state court order, and result in 15% of disposable pay being garnished. Administrative wage garnishments trump state court judgments.
 - vi. The Department of Justice can file lawsuits against debtors in default. This option is not common, and typically reserved for self-employed debtors.
 - vii. Default triggers negative impact on credit reports and credit scores.
- e. Curing default.
 - i. Beyond repaying the debt in full, student loan debtors have another option to cure default.
 - ii. *Rehabilitation.* Once in default status, a student loan debtor has the right to “rehabilitate” and exit default status **once** during the life of the loan.
 - 1. Debtor must make at least 9 payments within a 10 month time

period.

2. They can then exit default status.
3. This clears up credit reporting issues, and allows debtors to begin or resume a traditional student loan repayment plan.

f. Repayment plans for federal student loans.

- i. *Standard Repayment.* Fixed payments for 10 years. Starting point for all debtors.
- ii. *Graduated Repayment.* 10 year repayment term. Low payments for first two years, and increase in payments every two years thereafter.
- iii. *Extended Repayment.* Available to debtors with over \$60,000 in federal student loan debt. 25 year repayment term. 2 options:
 1. Option 1: Fixed monthly payments for 25 years.
 2. Option 2: Graduated payments. Monthly payments start low and increase every two years over a 25 year period.
- iv. *Income Contingent Repayment (ICR).* Formula based upon income and student loan balance will set monthly payment obligations each year. 25 year term. After 25 years, balance on federal student loans is canceled.
 1. Not as beneficial for debtors as IBR, as total student loan balance is incorporated into the formula.
 2. ICR can be used for Parent Plus loans, unlike IBR.
- v. *Income Based Repayment (IBR).* ***In many cases, this is the best option for student loan debtors.
 1. Monthly student loan payment based solely on income.
 2. To qualify, your payment under IBR must be less than your payment under the standard 10 year repayment plan.
 3. By default, IBR looks at the debtor's adjusted gross income for his or her most recent federal tax return.
 - a. If married and joint tax returns are filed, IBR looks at total household income.
 - b. If married and separate tax returns are filed, IBR only looks at the income of the debtor.
 4. Debtors pay 15% of their "discretionary income" for a 25 year term.
 5. "Discretionary income" is income over and above 150% of the poverty line for the debtor's household size.
 6. Example: John Debtor's adjusted gross income for 2011 is \$50,000 for a family of 3. The poverty line for a family of three is \$19,090, 150% of which is \$28,635. Debtor's "discretionary income" is \$21,365. 15% of \$21,365 is \$3,204.75. \$3,204.75 divided by 12 results in a monthly payment obligation of **\$267.06** per month.
 7. For most debtors, repayment term is 25 years. After 25 years, remaining balance is forgiven.
 8. For debtors who work in public service, the repayment term is only 10 years, with the remaining balance being forgiven after 120

qualifying monthly payments.

9. Under IBR, zero dollar payments are possible. In event of unemployment, don't take economic hardship deferment. Instead, drop payments to zero until income increases.
10. As income increases, payment increases. If income decreases, payment decreases.
11. Note that forgiveness of debt after 10 or 25 years is taxable.

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