Recent Developments in the Student Loan Dischargeability Analysis of Income Based Repayment Plans

By Zachary Sanderson
Markus Williams & Young LLC

On November 27, 2018, Secretary of Education Betsy DeVos publicly proclaimed that Federal Student Aid climbed to a $1.5 Trillion loan portfolio comprising "over 30 percent of all federal assets." She further noted that, "only 24 percent of FSA borrowers—one in four—are currently paying down both principal and interest. Nearly 20 percent of all loans are delinquent or in default," which is "seven times the rate of delinquency on credit card debt." Betsy DeVos, Secretary of Education, Remarks to Federal Student Aid's Training Conference (Nov. 27, 2018), available at *https://www.ed.gov/news/speeches/prepared-remarks-us-secretary-education-betsy-devos-federal-student-aids-training-conference*.

For many of these student borrowers, however, the bankruptcy discharge process fails to facilitate a "fresh start." Indeed, the Bankruptcy Code provides that student loans cannot be discharged "unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents." 11 U.S.C. § 523(a)(8). The Bankruptcy Code does not define "undue hardship." In applying the undue hardship test, the "overwhelming majority of the circuits," including the Tenth Circuit, have adopted the *Brunner* test. *Educ. Credit Mgmt. Corp. v. Frushour* (*In re Frushour*), 433 F.3d 393, 400 (4th Cir. 2005). The three-pronged *Brunner* test for undue hardship requires a debtor to show:

> (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 v. N.Y. State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir. 1987).

In contrast, the Eighth Circuit uses a totality of the circumstances test for undue hardship, which is a "less restrictive approach to the 'undue hardship' inquiry" than the *Brunner* test. *Long v. Educ. Credit Mgmt. Corp.* (*In re Long*), 322 F.3d 549, 554 (8th Cir. 2003). The Eighth Circuit preferred this approach because "fairness and equity require each undue hardship case to be examined on the unique facts and circumstances that surround the particular bankruptcy." *Id.*

Income-Based Repayment Plans

In 2007, the circumstances of student borrowers changed when Congress passed the College Cost Reduction and Access Act, which created Income-Based Repayment ("IBR"). Under IBR, a student borrower must make monthly payments of 15% of her discretionary income for 25 years. Discretionary income is defined as the difference between the borrower's income and 150% of the applicable poverty guideline. Since 2007, various other IBR plans have emerged and participation in these plans has increased: Pay-As-You-Earn Repayment Plan (10 percent of your

discretionary income, but never more than the 10-year Standard Repayment Plan amount for 20 years), Revised Pay-As-You-Earn Repayment Plan (10 percent of discretionary income for 20 or 25 years), and Income-Contingent Repayment Plan (the lesser of 20 percent of discretionary income or what you would be paid on a repayment plan with a fixed payment over the course of 12 years for 25 years). These plans all have two things in common. First, the debtor's income determines the monthly payment amount. In fact, if a student borrower's income is low enough, the borrower's monthly payments may be $0. Second, after making monthly payments under the plan for 20 or 25 years, depending on the plan, the remaining student loan balance is forgiven.

<u>Bankruptcy Courts' Views of IBR Plans</u>

In revisiting the issue and applying the more flexible totality of the circumstances test, bankruptcy courts in the Eight Circuit have subsequently addressed whether a $0 payment under these programs can still constitute an "undue hardship." In *Abney v. United States Dep't of Educ.* (*In re Abney*), 540 B.R. 681 (Bankr. W.D. Mo. 2015), the Court rejected the Department of Education's argument that the "mere availability of the [IBR plan] negates any finding of undue hardship." *Id.* at 688. The Court found that, in weighing the availability of such plans, courts should "be mindful of both the likelihood of a debtor making significant payments under the [income based repayment plans], and also of the additional hardships which may be imposed by these programs." *Id.*

The Bankruptcy Court in *Fern v. FedLoan Servicing* (*In re Fern*), 553 B.R. 362 (Bankr. N.D. Iowa 2016), followed and extended this reasoning:

> The hardships imposed by income-based repayment programs include (1) the continued accrual of interest and charges on the debt such that the debt would continue to grow during the 20 or 25 year period; (2) the effect of continually-increasing debt on a debtor's access to credit and on debtor's ability to obtain employment and housing; (3) the effect of mounting indebtedness, even with a zero or minimal payment on a debtor's mental and emotional state; and (4) the tax burden if the debt is canceled after 20 or 25 years of participation in the program. The Court balances these hardships against the likelihood that Debtor would make significant payments under an income-based repayment plan.

Id. at 369 (internal quotation marks and citation omitted).

As recently as this year, the Bankruptcy Court for the District of New Mexico has adopted a similar approach in examining the costs of IBR plans. *See Murphy v. United States* (*In re Murphy*), Nos. 15-11240-j7, 15-1051-j, 2018 Bankr. LEXIS 1598, at *32-33 (Bankr. D.N.M. June 1, 2018). The Court determined that the "negative consequences" of income based repayment plans includes being "required to jump through the hoops of applying each year to enroll in IBR plans" and having to "live with the stress of mounting student loan debt and the potential for exchanging one debt she cannot pay (the student loan debt) for another she cannot pay (tax debt resulting from forgiveness of the student loan debt)." *Id.*

Having rejected arguments that the mere availability of an IBR plan precludes a finding of undue hardship, Bankruptcy Courts are beginning to take a close look at the real costs of IBR plans. Now, the more flexible approach to the undue hardship injury pioneered in the Eight Circuit is gaining ground against the *Brunner* test in the 10th Circuit, at least in the IBR context, as courts are considering intangible hardships and costs in their analyses (e.g. administrative hassle and burden, and the emotional and psychological toll of mounting indebtedness on the borrower). These recent cases demonstrate that, although the statutory standard remains the same, the application of that standard continues to evolve.