The Changing Landscape Of Student Loan Dischargeability

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A recent decision out of the U.S. Bankruptcy Court for the Eastern District of Washington highlights a new difficulty that student loan borrowers face when attempting to discharge student loan debts in a bankruptcy case. Nationwide, student loan debt now totals more than $1 trillion, which is more than the total amount of American credit card debt. Because of the relatively recent increase in student loan debt, two things have happened: first, more borrowers are looking to the Bankruptcy Code to see if their student loan debts can be discharged, and second, the federal government has instituted a number of student loan repayment programs.

Income-based federal repayment programs, such as the Income Contingent Repayment plan (ICRP), the Income Based Repayment (IBR) plan and the Public Service Loan Forgiveness program, now give student loan borrowers several options in negotiating workable repayment terms for student loan debt. The idea is that borrowers will pay a certain percentage of their monthly income towards the debt, and after a certain number of years (for ICRP and IBR, 25 years), the remaining balance of the debt is forgiven. These programs thus give borrowers additional options in their financial planning — options that did not exist a decade ago.

These new repayment options, however, may make it more difficult for borrowers to obtain a discharge of their student loan debts under the Bankruptcy Code. Under 11 U.S.C. §523(a)(8), student loan debt, with some exceptions, cannot be discharged unless the debtor shows that if the debt is not discharged, it would create an "undue hardship on the debtor and the debtor's dependents." When looking to whether "undue hardship" exists, one thing courts look at is whether it is possible, in the future, for the borrower to make loan payments. Another thing courts review is whether the borrower has made a good-faith effort to make loan payments in the past.

Prior to the existence of programs such as ICRP and IBR, borrowers could provide evidence in support of meeting these factors by showing that their loan payments were too high, not tied to their income, and that the lender was not willing to reduce them. Now, due to ICRP and IBR, lenders have been making the argument that debtors cannot meet the "undue hardship" requirements because the potential exists for borrowers to sign up for ICRP and IBR, which would tie their repayment obligations to their income and even automatically discharge their debt after a set period of time. While bankruptcy courts are reluctant to adopt any extreme position, and many courts, including those in the Ninth Circuit, have refused to adopt a bright-line rule that a debtor's eligibility for ICRP and IBR makes it impossible for a debtor to show "undue hardship," the existence of these repayment programs has undoubtedly altered the calculus.

A cautionary tale of this new landscape is told in the Eastern District of Washington decision McCafferty v. United States Department of Education (In re McCafferty), 2015 Bankr. LEXIS 3600 (Bankr. E.D. Wash. Oct. 23, 2015). There, the married borrowers convinced the court that

they could not currently afford to make loan payments — one of the factors courts in the Ninth Circuit look to in determining undue hardship. They also convinced the court that their pay was not likely to be any higher in the future — another factor courts look to. But the bankruptcy court denied their discharge anyway for the sole reason that the borrowers did not investigate whether they were eligible for ICRP, IBR, or a similar income-based repayment program, nor did they attempt to negotiate with their lender to reduce their monthly payments.

The bankruptcy court, perhaps wary of a decision that could be interpreted to create a bright-line rule, stated that it made no decision as to whether any such repayment program would have been "prudent" for the debtors. The court might have denied the debtors relief even if they had investigated the possibility of signing up for such a program, but chose not to. But the takeaway is that any borrower seeking to discharge student loan debt in bankruptcy should, prior to commencing a bankruptcy case, make some effort to investigate these repayment programs and whether or not they are eligible for them, and additionally make some attempt to contact their lender to negotiate a reduction in payments. Borrowers can then use the facts learned and conclusions drawn from those experiences as evidence in support of why their student loan debt should be discharged, if appropriate.

Paradoxically, the sheer volume of American student loan debt may now be making courts uneasy about applying Section 523(a)(8) in a way that makes those debts easier to discharge. The existence of income-based repayment programs is an easy way for courts to rule against borrowers seeking a discharge, if those borrowers have ignored their existence or can provide no testimony as to why those programs are inadequate to solve their problems. Borrowers should grapple with these issues prior to commencing their case.

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