Testimony of Brett Weiss and Deanne Loonin for the

U.S. House of Representatives Committee on the Judiciary

Subcommittee on Commercial and Administrative Law

regarding

"Undue Hardship? Discharging Educational Debt in Bankruptcy"

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NATIONAL
CONSUMER LAW
CENTER®

7 Winthrop Square, 4th Floor
Boston, MA 02110
(617) 542-8010
www.consumerlaw.org

Mr. Chairman and Members of the Committee, the National Association of Consumer Bankruptcy Attorneys (NACBA) and the National Consumer Law Center (NCLC) thank you for holding this hearing today. The National Association of Consumer Bankruptcy Attorneys is the only national organization dedicated to serving the needs of consumer bankruptcy attorneys and protecting the rights of consumer debtors in bankruptcy. Formed in 1992, NACBA has over 4,000 members located in all 50 states and Puerto Rico. NACBA's members represent a large proportion of the individuals who file bankruptcy cases in the United States Bankruptcy Courts.

The National Consumer Law Center (NCLC) submits this testimony on behalf of our low-income clients. The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states that represent low-income and elderly individuals on consumer issues.[1] NCLC's Student Loan Borrower Assistance Project provides information about student loan rights and responsibilities for borrowers and advocates. We also seek to increase public understanding of student lending issues and to identify policy solutions to promote access to education, lessen student debt burdens and make loan repayment more manageable.[2]

Introduction: An Unfair System Based on False Assumptions

Current bankruptcy law treats students who face financial distress the same severe way as people who are trying to discharge child support debts, alimony, overdue taxes and criminal fines. This harsh treatment of students in the bankruptcy system was built on the false premise that students were more likely to "abuse" the bankruptcy system. Yet there is no evidence and has never been any evidence to support this assumption.

When first considering this policy, Congress commissioned a Government Accountability Office (GAO) study on the topic which found that only a fraction of 1 percent of all matured student loans had been discharged in bankruptcy. The House report summarized the GAO's findings:

> First, the general default rate on educational loans is approximately 18%. Of that 18%, approximately 3-4% of the amounts involved are discharged in bankruptcy cases. Thus, approximately ½ to ¾ of 1% of all matured educational loans are discharged in bankruptcy. This compares favorably with the consumer finance

[1] In addition, NCLC publishes and annually supplements practice treatises which describe the law currently applicable to all types of consumer transactions, including *Student Loan Law* (3d ed. 2006 and Supp.).
[2] *See* the Project's web site at http://www.studentloanborrowerassistance.org.

industry. [3]

Congress acknowledged the pressure from the anecdotal reports of abuse. For example, a 1977 House Report on this issue stated that:

> The sentiment for an exception to discharge for educational loans does not derive solely from the increase in the number of bankruptcies. Instead, a few serious abuses of the bankruptcy laws by debtors with large amounts of educational loans, few other debts, and well-paying jobs, who have filed bankruptcy shortly after leaving school and before any loans became due, have generated the movement for an exception to discharge. In addition, a high default rate has been confused with a high bankruptcy rate, and has mistakenly led to calls for changes in the bankruptcy laws.[4]

Despite the shaky foundation, Congress ignored the study and instead chose to make it more and more difficult for student loan borrowers to get a fresh start through bankruptcy.

After a series of changes which eliminated borrower rights, the final blow to students came in 2005 when Congress included private student loans in the non-dischargeability category. Private student loans are made by lenders to students and families outside of the federal student loan program. They are not subsidized or insured by the federal government and may be provided by banks, non-profits, or other financial institutions. Unfortunately, many private student lenders followed the path of the subprime mortgage industry and pushed high priced, unaffordable loans on students.

Diana, a mother of a college age son in West Virginia, told of her family's recent experiences with one such private lender:

> As a freshman at University of West Virginia, her son "…received scholarships and federally subsidized student loans that covered most of his tuition, room and board. Unbeknownst to his father and me, he began applying online for less conventional rate student loans to cover an estimated $1,800 balance. He had absolutely no credit history and absent a cosigner, most applications were denied. [The creditor's] student loan division, however, swiftly approved him for a $14,000 loan.
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> About a week after the check arrived, a disclosure statement followed that detailed a prepaid origination fee of $580 and a staggering total repayment of $57,327.79. Our naïve son thought that the interest rate was fixed; it was not. It is a variable rate that is currently at 11.3%.
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> We convinced him to send the check back, but when he called [the private creditor], a representative talked him into keeping it….We are outraged. [The private creditor] is clearly preying on and exploiting vulnerable and financially naïve students who will clearly be saddled with outrageous, crushing debt upon graduation."

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[3] H.R. Rep. 95-595, 1st Sess. 1977, 1978, 1978 U.S.C.C.A.N. 5963, 6094, 1977 WL 9628.
[4] Id.

The idea that students are more likely to file for bankruptcy also assumes that this decision is cost-free when in fact there are many negative consequences, such as damage to credit rating. Further, in 2005, Congress added a number of new elements to the personal bankruptcy system, such as a means test and counseling requirements, that make it more difficult for all consumers to file bankruptcy, especially those who have assets to pay their debts. In any case, the Bankruptcy Code has always included safeguards to prevent discharge in cases where debt is obtained through false pretenses or fraud.

On one hand, we tell young people as they grow up that they have a much better chance of success if they go to college. Yet we give these students no margin for error if college does not work out for them financially, even though it is in our national interest for more people to get post-secondary education or training. It would be better for society and our economic future if individuals were allowed some flexibility to take chances. If public policies only encouraged safe choices, few would borrow to go to college. Few would start businesses either. Most businesses fail, even those started by those who have previously run successful businesses.[5] Yet we have decided as a society that we want people to start businesses even if this means writing off some bad debt. The same principle should apply to education.

An Arbitrary System

To make matters even worse, the current "undue hardship" system is random, arbitrary and unfair. Under current law, most federal and private student loans can only be discharged if the debtor can show that payment will impose an undue hardship on the debtor and the debtor's dependents. The student must seek the hardship determination in court through a separate proceeding. While the current system may deter some student borrowers who can afford to pay their loans, it more often snares those who are truly financially distressed and desperately need relief.

The system is strikingly arbitrary. Judges are granted extraordinary discretion to make these decisions, especially since the Code provides no definition of "undue hardship." Professors Pardo and Lacey have studied this issue and found a high degree of randomness in the application of the undue hardship test.[6] They also found that students seeking bankruptcy relief were in fact suffering financial distress, concluding that judicial discretion has come to undermine the integrity of the undue hardship system.[7]

Many courts use the so-called *Brunner* test to evaluate hardship.[8] This test requires a showing that 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

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[5] Megan McArdle, "Sink and Swim" The Atlantic (June 2009).
[6] See Rafael I. Pardo & Michelle R. Lacey, "Undue Hardship in the Bankruptcy Courts: AN Empirical Assessment of the Discharge of Educational Debt", 74 U. Cin. L. Rev. 405 (2005); Rafael I. Pardo, Michelle R. Lacey, "The Real Student-Loan Scandal: Undue Hardship Discharge Litigation", 83 Am. Bankr. L.J. 179 (Winter 2009).
[7] Id.
[8] *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F. 2d 395 (2d Cir. 1987).

likely to persist for a significant portion of the repayment period of the student loans; and 3) the debtor has made good faith efforts to repay the loans.

In recent years, many judges have recognized the random and unfair application of this "test." According to the Tenth Circuit, many courts have "…constrained the three *Brunner* requirements to deny discharge under even the most dire circumstances."[9] The court further noted that this overly restrictive application fails to further the Bankruptcy Code's goal of providing a "fresh start" for the honest but unfortunate debtor.[10] In criticizing the test, another judge noted that *Brunner* was "…made up out of whole cloth anyway."[11] Among other nearly impossible barriers, the test forces borrowers to prove a negative—They must somehow prove that their future is as hopeless as their present.

Other courts have taken the *Brunner* test to the extreme of requiring that a borrower show a "certainty of hopelessness." In rejecting this analysis, some courts have blamed its widespread use on an erroneous reading of *Brunner*.[12]

Courts have taken the long journey from "undue hardship" to "certainty of hopelessness" because of the lack of guidance in the Code. Without such guidance, judges have freely injected their own views about what types of expenses are legitimate and whether a borrower is truly trying hard enough to earn a maximum income. This leads to results such as a 1994 decision where a debtor who had nerve damage, bronchitis, and arthritis, and whose daughter had epilepsy, mother had cancer and grandchildren had asthma, failing the Brunner "good faith prong" because she intentionally (and apparently wrongly in the court's view) chose to help her family financially.[13]

The Costs of Undue Hardship Litigation

The current system is stacked against the most financially distressed borrowers. These borrowers have few, if any, resources to pay for legal assistance to prove to judges that they suffer from undue hardship.

Yet competent legal assistance is one of the key factors in determining whether a borrower will successfully get a discharge. Professors Pardo and Lacey found that the extent of relief obtained by debtors turned more on extralegal factors than legal factors, including the identity of the creditor, the manner in which the adversary proceeding was resolved, identity of the judge and whether the debtor was represented by a highly experienced attorney.[14]

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[9] *ECMC v. Polleys*, 356 F. 3d 1302 (10th Cir. 2004).
[10] Id.
[11] *In Re Cummings*, 2007 WL 3445912 (Bankr. N.D. Cal. Nov, 13, 2007).

[12] *In re King*, 368 B.R. 358 (Bankr. D. Vt. 2007)
[13] *In re Stebbins-Hopf*, 176 B.R. 784 (Bankr. W.D. Tex. 1994),
[14] Rafael I. Pardo, Michelle R. Lacey, "The Real Student-Loan Scandal: Undue Hardship Discharge Litigation", 83 Am. Bankr. L.J. 179 (Winter 2009).

Unlike a typical consumer bankruptcy case, a student loan borrower must affirmatively seek an undue hardship determination. This requires filing a complaint, often conducting extensive discovery, and preparing evidence for trial. These are time-consuming cases. The small subset of bankruptcy lawyers that handle these cases generally charge high fees. The sad fact is that there are very few lawyers that are willing or able to handle these cases through free legal services or on a pro bono basis.

Without legal assistance, these borrowers must litigate undue hardship while going up against aggressive creditor lawyers. A borrower seeking no more than a fresh start must open up every aspect of his/her private life and defend it. Creditors have presented a wide range of aggressive arguments to discredit borrowers' testimony about hardship. In one recent case, creditors aggressively questioned a woman about why she had children after she took out student loans if she was not going to be able to afford both children and loans.[15] In this case, the creditor's counsel got the borrower to acknowledge that she had borne all of her children after she took out the loans. He then asked her if her children had been "planned" to which she responded that she was Catholic. Counsel then dropped the subject until closing argument, at that time referring to her religious choice. Counsel said that "you have to make the decision to have a family in light of what you can afford."

The arbitrary system hits lower-income borrowers particularly hard. Even if they have access to free or low cost legal assistance, they still must find resources to pay for depositions and in some cases even expert witness testimony. Even with strong testimony, it is nearly impossible to predict outcomes since so much rides on which jurisdiction the borrower happens to live in and which judge she draws. Inconsistency and unfairness have destroyed the credibility of the system. One judge noted the importance of a student loan program operating free of the "…cynicism that would infest the system if a disparate standard for discharge of loans would develop, leaving some students enduring the hardship of making loan payments while others are freed of their commitment on a floating standard."[16] Unfortunately, this is the state we are in.

The Impact on Co-Borrowers and Victims of Rip-Off Schools

There are subsets of borrowers that are particularly impacted by these inequities. Most courts, for example, have extended the same restrictive standards to co-borrowers. We recently heard a particularly poignant experience from a co-borrower looking for solutions:

> Heather from St. Petersburg, FL (in her words)
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> I co-signed for my boyfriend's loans so that he could go to school to become a pilot. When he signed up with the school, they only had 2 banks they wanted us to get loans through (Wachoiva or Sallie Mae and only one that was accessible from their web site (Wachovia) where he was supposed to sign up for the loan. So we ended up getting a private loan from Wachovia (which is backed by TERI) instead of a federal loan, although I'm not sure what the difference is. Unfortunately, he passed away a couple of weeks before his training was complete. Now the loan deferment period is

[15] *In re Walker*, 406 B.R. 840 (D. Minnesota June 18, 2009),
[16] *ECMC v. Polleys*, 356 F. 3d 1302 (10th Cir. 2004) (J. Lucero concurring opinion).

> coming to and end and obviously they want their money. I've done some outreach to see what my options are and it's not looking very promising… They also sent a letter, addressed to him, stating that the loans don't offer a death discharge….. I understand that I am responsible for paying these loans since I did co-sign for them, it just doesn't make sense for me to pay the entire loan amount when I got nothing from them, didn't even get to go for a ride!

Most courts are similarly unmoved by borrowers who went to fraudulent schools. Most courts have struggled to fit the concept of "educational benefit" into the undue hardship analysis even in cases where the school closed while the borrower was in attendance or was otherwise a sham school.[17] Many courts assume that these borrowers can get relief instead through the Department of Education administrative discharges. This may be true in some cases, but there are many limits to these discharges which most bankruptcy judges are not aware of. First, these discharges apply only to federal student loans. In addition, many borrowers fall through the cracks of the limited closed school, false certification, and unpaid refund eligibility provisions. Not one of these discharge programs provides general remedies for borrowers who attended a fraudulent school. For example, a school may routinely pay admissions officers by commission in violation of incentive compensation rules, fail to provide educational materials or qualified teachers, and admit unqualified students on a regular basis. None of these violations is a ground for cancellation. Instead, each cancellation offers relief for a narrow set of circumstances.

Lack of Non-Bankruptcy Alternatives

The bankruptcy policy might not be so harsh if borrowers had ample non-bankruptcy alternatives to address student loan problems. There are many options in the federal loan programs, although these should not be viewed as substitutes for bankruptcy discharges in all cases. Private loans, however, are another story.

Given their role in creating the crash, it is reasonable to expect lenders to do everything possible to help borrowers with unaffordable loans. Distressingly, this has not occurred. In NCLC's experience representing borrowers through the Student Loan Borrower Assistance Project. we have found private lenders to be universally inflexible in granting long-term repayment relief for borrowers. Lenders that had no problem saying "yes" to risky loans are having no problem saying "no" when these borrowers need help.

In NCLC's April 2009 report, "Too Small to Help: The Plight of Financially Distressed Private Student Loan Borrowers", we found that private lenders appear to be offering some flexible repayment options for financially distressed borrowers.[18] Private lenders, however, do not offer income-based repayment. In addition, these lenders rarely cancel loans or offer reasonable settlements. For example, private lenders generally do not

[17] *See, e.g., In re Gregory* 387 B.R. 182 (N.D. Ohio 2008) (Relief on the basis of fraud can be had only against those who are shown to be parties to the fraud).

[18] The report is available on-line at: http://www.studentloanborrowerassistance.org/uploads/File/TooSmalltoHelp.pdf.

discharge student loan debt upon death of the original borrower or co-signer. Further, loan modifications are rarely offered. Fundamentally, lenders who make private student loans are not obliged to offer repayment modification or relief under any circumstances, leaving borrowers truly at the mercy of their lenders.

The options are particularly limited for borrowers in default. Yet these are generally the borrowers most desperate for assistance. This is also in sharp contrast to the federal student loan programs where borrowers in default have various ways to select affordable repayment plans and get out of default.

In the past, forbearance was the only option private student lenders offered to these most distressed borrowers. However, these policies have changed radically in recent months as most creditors have sharply restricted forbearance availability. The problem for borrowers is not so much that forbearances are less available, but that there are few or no other options to help them manage their debts over the long-term. Forbearances are not the best long-term debt management tool because interest accrues during the forbearance period, but it is the only tool many borrowers have traditionally been offered to stave off default.

We constantly hear from borrowers who are desperate to work something out with their lenders only to have the door slammed in their faces. Here are accounts from a few such borrowers:

1. Patrick from the Greater Boston Area, MA

   Patrick's mother was one of NCLC's clients. Patrick was 22 years old in 2006, just a semester away from graduating from the University of Rhode Island, when his life changed forever. He suffered a terrible accident, falling down a long escalator and suffering severe brain damage. His parents, doctors and nurses have fought hard to keep him alive, but the prognosis is not good. Patrick is in a minimally conscious state and is incapable of consistent communication, fully dependent upon others for all of the activities of daily life.

   Patrick's family has struggled to find resources to pay for his care. There was no appropriate care available in Massachusetts, so they are paying for private care in New Hampshire. They are also using up their retirement and other resources to retrofit their home so that it will be accessible for Patrick when they bring him home.

   Patrick took out federal loans to finance his education and also worked during the summers to earn money for college. His federal loans were discharged based on permanent and total disability. He also used private loans to help fill the gap. To get a better rate, his mother co-signed on the loans. These were not the highest rate private loans. Because Patrick's Mom co-signed, they were able to get a decent interest rate. The problem is the lack of a safety net when this tragedy occurred.

Patrick's Mom has struggled to make the monthly payments. She has done so up until now, but the extra resources needed to pay for Patrick's care have put her over the edge. In addition, her husband was recently diagnosed with a serious illness. Patrick's Mom has asked the lender to forgive the remaining balances. Alternatively, she has offered to settle the debt for less than the amount owed through payment of a lump sum. To date, the lender has refused, offering nothing more than short-term forbearances or short periods of interest only payments.

2. Monica from Dallas, TX (in her own words)

I have two loans, one of which is private. Two times today, I tried to resolve my private loan that is in default. First speaking with a woman who called me and second speaking with a woman who I called. Both times, the women were very rude and spoke over me, not allowing me to speak or ask any questions. ..She told me she didn't care about my situation and that if I don't get out my check book and pay them a deposit, they are going to sue me. I told her I was calling to try to resolve my issue, that I called them and I am not trying to avoid payment. She hung up on me. I called with the intent to help the situation I was on and try to get on the right rack, and honestly, put down the phone wanting to shoot myself.

Even the Middle Ground is Arbitrary

Many courts, recognizing the inequity of this system, have begun to create an ad hoc middle ground. Some allow partial relief by discharging a portion of the debt or by discharging some, but not all, of the loans. Some courts have allowed a restructuring of the loan, for example by discharging collection fees and accrued interest and even by delaying the student's obligation to start making payments, during which time no further interest accrues.

Whether a borrower gets the benefit of a middle ground approach depends entirely on where she happens to live and the judge she happens to draw. This is unfair, but the judges have a point. They are flying by the seat of their pants without any foundation in the bankruptcy code because they understand that the current all or nothing approach is unfair.

Effect on the Student Loan Business

Many creditors argue that treating student loans the same as other debts in bankruptcy would create greater risk for them. This is far from obvious. If most borrowers who file for bankruptcy cannot afford to repay their debts, a more restrictive bankruptcy policy is not going to make them more able to pay.

It is certainly true that private student loans, made without government guarantees, can be risky for both creditors and borrowers. Many students are young, with little or no credit history. Their earning power is mostly speculative. Yet responsible underwriting of student loans is not impossible. Recent trends in the industry show that creditors know how to sell less risky products.

However, lenders will not necessarily stop lending because of too much risk. In fact, creditors kept lending in recent years despite the huge risks, ultimately fueling the current economic crisis. Creditors generated huge profits making risky student loans mainly because they sold the loans after origination, passing the risk along the food chain.

There is no evidence that student loan creditors adjusted their lending in response to changes in bankruptcy law. The private student loan market was growing rapidly well before Congress in 2005 made private student loans harder to discharge. The private student loan market grew at an average annual rate of about 27% between 2000-01 and 2005-06, after adjusting for inflation.[19] This should not be so surprising. During the past decades of irresponsible lending, creditors threw credit around like candy in markets where the credit was dischargeable in bankruptcy (such as credit cards) and those where it was harder to write off debts in bankruptcy.

There is simply no good evidence that bankruptcy policy affects creditor behavior. Interest rates, for example, were largely the same before and after the 2005 bankruptcy law which made private student loans more difficult to discharge in bankruptcy. Until recently, the private student loan market was growing rapidly, but there is no proof that this was because of the stricter bankruptcy policy. The market has shrunk dramatically in the last year even with a restrictive bankruptcy policy.

In any case, it does not make sense to restrict student bankruptcy rights because of theoretical fears that this will make student loans less available. As we noted earlier, there is no evidence that bankruptcy policy affects the volume of loans. Further, the recent tightening of the credit market has helped eliminate loans that never should have been made. This has forced schools and lenders to think twice before pushing these high priced products. We believe that this is a welcome market correction.

We work with borrowers every day to help them address student loan problems. If you ask our client John whether there is a crisis, he would not point to a lack of access to credit, but rather the fact that the credit he did get is ruining his future plans. A few years ago, he took out a federal loan and a high-cost private loan to attend a local proprietary school. John withdrew after one semester because the program the school promised he would be able to take was not being offered. John is 23 years old and suffers from severe depression. He has been unable to recover and go back to school. He has been able to figure out ways to manage his federal loans, but not the private student loans. He now faces a lawsuit for collection of his private loans.

You will likely hear similar sentiments from the approximately 2,500 former students of Silver State Helicopters, a Nevada-based for-profit flight school that recently went into bankruptcy. Most of these students received private loans to cover costs and are stuck with incomplete educations from a school that abruptly closed, while also facing demands from lenders insisting on repayment.

[19] College Board, *Trends in Student Aid 2006* (2006).

Conclusion

Bankruptcy policy should be about the pragmatic need to offer fresh starts to many debtors. Bankruptcy is the legal recognition that someone lacks the resources to meet financial obligations. There are many rules in place to ensure that only borrowers who are financially distressed get relief. It is way past time to give financially distressed student borrowers equal access to relief.