



**Exempt Assets May Not be Considered When Determining if Student Loan Should be Discharged**

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**INTRODUCTION**

Student loans are presumptively non-dischargeable under title 11 of the United States Code (the “Bankruptcy Code”).<sup>1</sup> The Bankruptcy Code, however, provides that a debtor may rebut the presumption and be discharged from student loans if the debtor can prove that exempting the debt from discharge would cause “undue hardship” on the debtor or the debtor’s dependents.<sup>2</sup> Proving undue hardship is a “formidable task” for a debtor, but not an impossible one.<sup>3</sup> The Bankruptcy Code does not define undue hardship and does not provide bankruptcy courts with any guidance on how to evaluate it.<sup>4</sup> Accordingly, Congress has given bankruptcy courts substantial discretion to define undue hardship on their own.<sup>5</sup> Primarily two different tests have evolved and have been adopted to evaluate undue hardship in a judicial effort to reduce inconsistencies and create clearer guidelines: the totality of the circumstances test and the *Brunner* test.<sup>6</sup>

<sup>1</sup> *Ayele v. Educ. Credit Mgmt. Corp.*, 490 B.R. 460, 462 (D. Mass. 2013).

<sup>2</sup> 11 U.S.C. § 523(a)(8) (2018).

<sup>3</sup> See *Nash v. Conn. Student Loan Found. (In re Nash)*, 446 F.3d 188, 191 (1st Cir. 2006).

<sup>4</sup> *Ablavsky v. U.S. Dep’t of Educ. (In re Ablavsky)*, 504 B.R. 709, 718 (Bankr. D. Mass. 2014).

<sup>5</sup> *Fox v. Pa. Higher Educ. Assistance Agency (In re Fox)*, 163 B.R. 975, 978 (Bankr. M.D. PA 1993).

<sup>6</sup> See *id.* at 979; *Long v. Educ. Credit Mgmt. Corp. (In re Long)*, 322 F.3d 549, 553 (8th Cir. 2003).

While the adoption of one test or the other has enabled the courts to create and apply clearer standards, there remains an ambiguity with regard to consideration of exempt assets when evaluating undue hardship. Exempt assets ordinarily are “to be liberally construed for the benefit of debtors,” as a matter of public policy and in order to facilitate a debtor’s fresh start.<sup>7</sup> However, because of different judicial opinions regarding exempt assets, one question emerges: may a debtor’s exempt assets be considered in a bankruptcy court’s undue hardship analysis? This memorandum addresses this question in a tripartite method. Part I examines the two tests for evaluating undue hardship: the “totality of the circumstances” test and the so-called “*Brunner* test.” Part II discusses exempt assets, and Part III concludes by analyzing the treatment of exempt assets under both tests.

## I. THE TWO UNDUE HARDSHIP STANDARDS

### A. THE *BRUNNER* TEST

The United States Court of Appeals for the Second Circuit in *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987) established a three part test to prove undue hardship. Under the *Brunner* test, which has been adopted by a majority of the circuits,<sup>8</sup> a debtor may be discharged from student loans if the debtor can demonstrate “(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.”<sup>9</sup> Notably,

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<sup>7</sup> *Schatz v. Access Grp., Inc. (In re Schatz)*, 602 B.R. 411, 424 (1st Cir. 2019).

<sup>8</sup> The second, third, fourth, fifth, sixth, seventh, ninth, tenth, and eleventh circuits have all adopted the *Brunner* test. See *Thomas v. Dep’t of Educ. (In re Thomas)*, 931 F.3d 449, 452–53 (5th Cir. 2019).

<sup>9</sup> *Brunner*, 831 F.2d at 396.

all three prongs of this test must be met in order for a debtor to receive a discharge of student loans.<sup>10</sup>

Bankruptcy courts applying the *Brunner* test still must analyze each individual debtor's circumstances.<sup>11</sup> Courts have noted that circumstances such as having (i) dependents, (ii) a disability, (iii) no job prospects, or (iv) anything else that would affect a debtor's ability to pay student loans, should be considered.<sup>12</sup> However, a debtor must establish that the alleged undue hardship is more than a "present financial difficulty," and is likely to persist through the foreseeable future.<sup>13</sup> Further, the timing of when a debtor files for bankruptcy seeking a discharge, from when the student loans first became due, is significant to assess good faith efforts to repay the loans under the third prong of the test.<sup>14</sup> In some cases, a court may also consider whether a debtor first sought a deferment of payment, "a less drastic remedy [than filing for bankruptcy,] available to those unable to pay because of prolonged unemployment."<sup>15</sup> A "total foreclosure of job prospects" is also an important consideration that a bankruptcy court should weigh under the second prong of the *Brunner* test. However, the period of time spent searching for employment is crucial.<sup>16</sup>

## **B. TOTALITY OF THE CIRCUMSTANCES TEST**

A minority of circuits apply the totality of the circumstances test, expressing a preference for a less restrictive standard as compared to *Brunner*.<sup>17</sup> A bankruptcy court that applies the totality

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<sup>10</sup> *See id.*

<sup>11</sup> *In re Long*, 322 F.3d at 554.

<sup>12</sup> *Brunner*, 831 F.2d at 396–97.

<sup>13</sup> *Bronsdon v. Educ. Credit Mgmt. Corp. (In re Bronsdon)*, 435 B.R. 791, 799 (B.A.P. 1st Cir. 2010).

<sup>14</sup> *See Brunner*, 831 F.2d at 397 (holding there was no good faith effort to repay student loans where the debtor filed for discharge one month after the first payment became due).

<sup>15</sup> *Id.*

<sup>16</sup> *See id.* (stating that ten months spent searching for a job after graduation was insufficient to find the debtor had no future job prospects).

<sup>17</sup> *See In re Long*, 322 F.3d at 554. The First and Eighth circuits are the only two circuit courts to currently apply the totality of the circumstances test. However, neither circuit has formally adopted the totality of the circumstances test as the only standard. *See In re Schatz*, 602 B.R. at 417; *In re Long*, 322 F.3d at 554.

of the circumstances test would consider the following: “(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.”<sup>18</sup> Under the third prong of this test, other relevant facts would include: the debtor’s income and expenses, health, age, education, number of dependents, other family circumstances, amount of monthly payment required, and ability to find a higher paying job, to move or cut living expenses.<sup>19</sup> The totality of the circumstances test has been described as asking: “[c]an the debtor now, and in the foreseeable future maintain a reasonable, minimal standard of living for the debtor and the debtor’s dependents and still afford to make payments on the student loans?”<sup>20</sup> Thus, if a debtor’s future income and other financial resources will sufficiently cover the student loan payments, while still allowing the debtor to maintain a minimal living standard, a court will likely not grant a discharge of student loans.<sup>21</sup>

The totality of the circumstances test is “fact-intensive,”<sup>22</sup> and no one factor is dispositive.<sup>23</sup> Accordingly, bankruptcy courts will consider a broad range of “other relevant information that would be persuasive to overcome the income and expense analysis... under the first two factors” of the test, including:

- (1) total present and future incapacity to pay debts for reasons not within the control of the debtor;
- (2) whether the debtor has made a good faith effort to negotiate a deferment or forbearance of payment;
- (3) whether the hardship will be long-term;
- (4) whether the debtor has made payments on the student loan;
- (5) whether there is permanent or long-term disability of the debtor;
- (6) the ability of the debtor to obtain gainful employment in the area of the study;
- (7) whether the debtor has made a good faith effort to maximize income and minimize expenses;
- (8) whether the

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<sup>18</sup> *In re Abalavsky*, 504 B.R. at 554.

<sup>19</sup> *Hicks v. Educ. Credit Mgmt. Corp. (In re Hicks)*, 332 B.R. 18, 31 (Bankr. D. Mass. 2005) (quotations omitted).

<sup>20</sup> *Id.*

<sup>21</sup> *In re Long*, 322 F.3d at 554–55.

<sup>22</sup> *In re Schatz*, 602 B.R. at 426.

<sup>23</sup> *See Morgan v. U.S. Dept. of Higher Educ. (In re Morgan)*, 247 B.R. 776, 782 (Bankr. E.D. Ark. 2000) (“No one factor alone will prove or disprove undue hardship.”). *See also In re Long*, 322 F.3d at 554 (stating that this approach reflects the fact that the lives of debtors are complex and each case should be evaluated individually).

dominant purpose of the bankruptcy petition was to discharge the student loan; and (9) the ratio of student loan debt to total indebtedness.<sup>24</sup>

## II. EXEMPT ASSETS

When an individual files for relief under the Bankruptcy Code a bankruptcy “estate” is automatically created, consisting of all “legal and equitable interests of the debtor in property.”<sup>25</sup> However, the Bankruptcy Code allows for individual debtors to exempt certain property from the estate, putting it beyond the reach of creditors, and allowing the debtor to retain same post-bankruptcy.<sup>26</sup> See 11 U.S.C. § 522(c) (providing that exempted property will not be liable to pay any debt that arose prior to the commencement of the bankruptcy case). Section 522(d) provides a list of property that a debtor may elect to exempt, however commonly only up to a stated aggregate value. An often invoked exemption from this list is the “homestead” exemption, which allows a debtor to exempt and retain up to a certain amount of interest in real property,<sup>27</sup> if used by the debtor as a residence.<sup>28</sup> In addition, some states provide an alternative to the federal exemption list, and a debtor may choose to utilize either the federal or their state’s exemption list, unless the state law in which the debtor resides does not so authorize.<sup>29</sup>

Once a debtor elects an exemption, either under federal or state law, the bankruptcy court “may not refuse to honor the exemption, absent a statutory basis for doing so.”<sup>30</sup> For instance, the Bankruptcy Code has enumerated certain exceptions to the general rule that exempted assets are not liable for pre-petition debts.<sup>31</sup> In regard to student loans, section 522(c) provides that exempt property may be liable for student loan debt when such loans were obtained

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<sup>24</sup> *Fern v. FedLoan Servicing (In re Fern)*, 563 B.R. 1, 4–5 (B.A.P. 8th Cir. 2017).

<sup>25</sup> 11 U.S.C. § 541(a).

<sup>26</sup> See 11 U.S.C. § 522(d).

<sup>27</sup> The amount of the federal homestead exemption is frequently adjusted. Currently, debtors are allowed to retain up to \$25,150 in real property used as a residence. See 11 U.S.C. § 104 (2018).

<sup>28</sup> *Id.*

<sup>29</sup> 11 U.S.C. § 522(b)(2); see also Mass. Gen. Laws ch. 188 §§ 1, et seq. (2010) (providing a more generous state homestead exemption than the Bankruptcy Code).

<sup>30</sup> *Law v. Siegel*, 571 U.S. 415, 424 (2014).

<sup>31</sup> See *id.* (explaining that the exceptions generally relate to debtor misconduct).

fraudulently.<sup>32</sup> Accordingly, because Congress explicitly enumerated fraud as the only exception, fraud in connection with obtaining a student loan is the only ground for which a bankruptcy court may refuse to honor an exemption and hold exempt property liable to satisfy pre-petition student loan debt.<sup>33</sup>

While the *Brunner* test and the totality of the circumstances test have a number of differences, one notable difference is the consideration of exempt assets under each test's undue hardship evaluation. Some bankruptcy courts, applying the *Brunner* test, allow consideration of exempt assets, listing, "assets, whether or not exempt, which could be used to pay the loan" as one factor.<sup>34</sup> However, the First Circuit, applying the total of the circumstances test, held that consideration of exempt assets may not be given "dispositive weight" in a bankruptcy court's undue hardship analysis.<sup>35</sup>

### III. CONSIDERATION OF EXEMPT ASSETS UNDER UNDUE HARDSHIP ANALYSIS

The United States Court of Appeals for the First Circuit is the first court to thoroughly consider exempt assets and their role in an undue hardship analysis.<sup>36</sup> Schatz was a single mother who suffered from several medical conditions, and was unable to find a job in the legal field after graduating from law school, an education which she financed almost entirely through student loans.<sup>37</sup> After voluntarily filing a petition for relief under chapter 7 of the Bankruptcy Code, she claimed a homestead exemption under the Massachusetts state law exemption list in order to protect the value of her home, which she listed as \$165,000.<sup>38</sup> Schatz also sought discharge of her student loan debt, which amounted to approximately \$110,000, alleging that repaying the

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<sup>32</sup> 11 U.S.C. § 522(c).

<sup>33</sup> *See id.*; *Law*, 571 U.S. at 424.

<sup>34</sup> *Educ. Credit Mgmt. Corp. v. Nys (In re Nys)*, 466 F.3d 938, 947 (9th Cir. 2006).

<sup>35</sup> *In re Schatz*, 602 B.R. at 428–29.

<sup>36</sup> *See id.* at 426–27.

<sup>37</sup> *Id.* at 413, 415.

<sup>38</sup> *Id.* at 413.

loans would leave her with a monthly income deficit of \$76.11, and thus cause her to suffer undue hardship.<sup>39</sup> The bankruptcy court in its analysis failed to consider many relevant factors, such as Schatz's medical ailments or her future earning capacity.<sup>40</sup> Rather, the bankruptcy court found that "the existence of substantial equity in the Debtor's Property that can be used to pay these student loans in full" was dispositive without considering Schatz's invocation of the homestead exemption, and subsequently denied the discharge.<sup>41</sup>

On direct appeal, the First Circuit held that the bankruptcy court misapplied the totality of the circumstances test because of the probative weight it assigned the exempt equity in the debtor's home.<sup>42</sup> The First Circuit did recognize that courts in other circuits, namely those applying the *Brunner* test, do list "a lack of assets, exempt or otherwise" among factors that may be considered to assess undue hardship.<sup>43</sup> However, the First Circuit found that these other courts simply placed exempt assets on a non-exhaustive list of considerations without evaluating the interplay between section 522(c) and section 523(a)(8).<sup>44</sup> Thus, these courts ignored the Congressional determination that creditors will not be allowed to "access exempt assets for payment of pre-petition student loan debt in the absence of...debtor fraud" in connection with securing the loan.<sup>45</sup> Accordingly, the court noted, "we can find no prior case in which a court considered the existence or amount of exempt home equity as a prime factor in assessing the discharge of student loans due to undue hardship."<sup>46</sup> Subsequently, the court remanded the case for a proper analysis under the totality of the circumstances test—one that does not "short-circuit"

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<sup>39</sup> *Id.* at 414.

<sup>40</sup> *Id.* at 429.

<sup>41</sup> *Id.* at 418.

<sup>42</sup> *Id.* at 428.

<sup>43</sup> *See id.* at 426 (quoting *In re Nys*, 466 F.3d at 947).

<sup>44</sup> *See id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

the analysis and accords proper weight to all relevant factors, such as Schatz's future earning capacity, impacted by her various health conditions.<sup>47</sup>

Further, those bankruptcy courts that allow consideration of exempt assets in an undue hardship analysis under the *Brunner* test still provide that discharge of student loans depend upon the complete and unique circumstances of each individual debtor.<sup>48</sup> Thus, if the loss of an exempt asset would "exacerbate a situation of undue hardship" of a specific debtor, that debtor would not be precluded from receiving a discharge under the *Brunner* test merely due to the existence of an exempt asset.<sup>49</sup> Consequently, exempt assets are not accorded dispositive weight under either the totality of the circumstances test, or a proper application of the *Brunner* test.

## CONCLUSION

Under either *Brunner* or the totality of the circumstances test, the existence of exempt assets is not outcome determinative in regard to whether a debtor receives a discharge of student loan debt.<sup>50</sup> Bankruptcy courts must consider all of an individual's unique circumstances in determining whether to grant a discharge of student loans.<sup>51</sup> If repayment of the student loans would cause the debtor to suffer undue hardship, a bankruptcy court should discharge same without relying on the fact that a debtor may have sufficient exempt assets to pay back the loan in full.<sup>52</sup> Consequently, exempt assets may not influence a bankruptcy court's student loan discharge determination whether it applies the *Brunner* or the totality of the circumstances test.

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<sup>47</sup> *Id.* at 428–29.

<sup>48</sup> *See Armesto v. N.Y. State Higher Educ. Servs. Corp. (In re Armesto)*, 298 B.R. 45, 48–49 (stating that student loan discharge will always boil down to the same question, "namely whether repayment of the student loan will impose an undue hardship on the debtor and her dependents").

<sup>49</sup> *See id.* ("Nothing in section 523 of the Bankruptcy Code requires a forfeiture of every asset as a precondition for discharge of a student loan.")

<sup>50</sup> *See In re Schatz*, 602 B.R. at 428–29.

<sup>51</sup> *See In re Armesto*, 298 B.R. at 48.

<sup>52</sup> *See id.* at 48–49.