



## Student Loans can be Discharged (at Least Partially) in Bankruptcy After All

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### Introduction

Section 523 of the Bankruptcy Code sets forth debts that are not dischargeable. Among the non-dischargeable debts, which a debtor will still owe after they receive a bankruptcy discharge, are debts from educational loans.<sup>1</sup> As such, these student loan debts may prevent many debtors from receiving a truly fresh start following bankruptcy. Courts historically have approached the undue hardship exception to this rule narrowly, applying it only where the debtor, under the circumstances, could not reap the benefit of her education<sup>2</sup>.

This Article will discuss the various tests courts use to determine whether an educational debt is dischargeable. Part I will discuss the totality of the circumstances test, which represents an older, and stricter perspective. Part II will discuss the *in re* Johnson test, which is another minority approach to the issue. Part III will analyze the Brunner test, which courts predominantly employ when considering whether student loans should be discharged. Finally, Part IV will discuss the implications of the split.

### I. The Totality of the Circumstances Test

<sup>1</sup> See 11 U.S.C. § 523 (a)(8) (“any other educational loan”).

<sup>2</sup> See, e.g., *In re Norman*, 25 B.R. 545, 550 (Bankr.S.D.Cal.1982) (psychiatric problems prevent work); *In re Siebert*, 10 B.R. 704, 705 (Bankr. S.D. Ohio 1981) (lack of usable job skills and severely limited education); *Krieger v. Educational Credit Management Corp.* (elderly status and inexperience prevented job opportunities).

One test courts have applied is the totality of the circumstances test adopted by the Eighth Circuit in *Long v. Educational Credit Management Corp. (In re Long)*.<sup>3</sup> Under this test, the court considers (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>4</sup> The court considered this to be a “less restrictive” approach than the Brunner test, since it could consider the facts and circumstances of each case in determining what is fair and equitable<sup>5</sup>. In order to satisfy this test, the debtor simply has to prove that if she is forced to pay the loans, she cannot maintain a minimal standard of living<sup>6</sup>. The court will consider “assets, expenses, and earnings” of the debtor, along with any predictable future changes<sup>7</sup>.

The Eighth Circuit re-affirmed this test in *In re Reynolds*, where it took an even more flexible approach and cautioned against too narrow a reading of the totality of the circumstances test<sup>8</sup>. In that case, a woman with extensive law school debt was unable to practice in the field of law due to severe mental illness and depression<sup>9</sup>. She was earning an income and had the capacity to make loan payments at least in part<sup>10</sup>. However, the court discharged her loans despite her ability to pay citing her mental illness as an extenuating circumstance, since the burden of paying her loans would cause her mental illness to worsen, which in turn may cause

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<sup>3</sup> See *Long v. Educational Credit Management Corp. (In re Long)*, 322 F.3d 549 (8th Cir. 2003), see also *In re Bronsdon*, 435 B.R. 791 (B.A.P. 1st Cir. 2010).

<sup>4</sup> See *Long v. Educational Credit Management Corp. (In re Long)*, 322 F.3d 549 (8th Cir. 2003).

<sup>5</sup> *Id.* at 554

<sup>6</sup> *Id.* at 554-555.

<sup>7</sup> *Id.* at 555.

<sup>8</sup> *In re Reynolds*, 425 F.3d 526, 532 (8th Cir. 2005)

<sup>9</sup> *Id.* at 528.

<sup>10</sup> *Id.* at 529.

her to be unable to work<sup>11</sup>. This flexible approach may be even more liberal than the Brunner Test discussed below.

## II. The *In re Johnson* Test

Another test courts have applied is the *In re Johnson* test which sets forth three-prong test for assessing the debtor's hardship. This comprises of a mechanical examination, a good faith examination and a policy examination.<sup>12</sup> For the mechanical examination, the court considers whether the debtor can achieve standard of living above the poverty line over the longest possible lifetime of the loan while repaying the loan.<sup>13</sup> The good faith examination requires the court to inquire as to (1) whether the debtor was negligent in her efforts to maximize income and minimize expenses, and (2) if yes, would the mechanical examination be altered if no negligence were found.<sup>14</sup> Finally, for the policy examination, the court asks whether the circumstances demonstrate that the primary purpose of the bankruptcy was to discharge this type of debt or whether the debtor has benefitted financially from the education, which the loan financed.<sup>15</sup>

The Eleventh Circuit followed this test in *In re Morris*, discharging the debts of a computer science major who was never employed in his field and suffered from severe panic attacks.<sup>16</sup>

## III. The *Brunner* Test

The majority of courts apply the test from *Brunner v. New York State Higher Education Services Corp.* when determining whether repayment of the debt was an undue hardship.<sup>17</sup> This

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<sup>11</sup> *Id.* at 531.

<sup>12</sup> *See In re Johnson*, 5 Bankr.Ct.Dec. 532 (Bankr. E.D. Pa. 1979).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

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

<sup>16</sup> *Morris v. United States, Dep't of Educ. (In re Morris)*, 2000 Bankr. LEXIS 1643.

<sup>17</sup> *See Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395, 396 (2d Cir. 1987); *see also In re Faish*, 72 F.3d 298, 300 (3d Cir. 1995), *In re Mosko*, 515 F.3d 319, 323 (4th Cir. 2008), *In re Gerhardt*, 348 F.3d 89, 91 [American Bankruptcy Institute Law Review](#) | St. John's School of Law, 8000 Utopia Parkway, Queens, NY

three-step test, which has been adopted by a majority of courts, a court will determine (1) whether “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) whether “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,” (3) whether “the debtor has made good faith efforts to repay the loans.”<sup>18</sup> Unlike the Totality of the Circumstances Test, the first part of the *Brunner* Test requires a prerequisite showing of inability to pay, regardless of other circumstances<sup>19</sup>. If the debtor has the ability to repay the loans, she does not qualify for undue hardship under the *Brunner* Test<sup>20</sup>. Additional circumstances the court may consider include, but are not limited to age, disability, and dependents<sup>21</sup>. Further, evidence of bad faith may include immediate filing after the loans become due, and failure to request deferment<sup>22</sup>.

In *Brunner*, the debtor actually did not satisfy this test.<sup>23</sup> The court found that there were no additional circumstances at play that indicated her financial state was likely to persist, given that she had recently graduated and was not elderly or disabled.<sup>24</sup> Further, the debtor made no good faith attempt to negotiate with her creditors, or ask for a deferment during her period of financial crisis.<sup>25</sup>

In *In re Shirzadi*, a court in the Southern District of Indiana refused to grant either a full or partial discharge where the debtor was not maximizing her income and minimizing her

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(5th Cir. 2003), *In re Barrett*, 487 F.3d 353, 358 (6th Cir. 2007), *Hedlund v. Educ. Res. Inst. Inc.*, 718 F.3d 848, 851 (9th Cir. 2013), *In re Alderete*, 412 F.3d 1200, 1204 (10th Cir. 2005).

<sup>18</sup> See *Brunner*, 831 F.2d at 396.

<sup>19</sup> *Id.*

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

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 397.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

expenses.<sup>26</sup> The debtor was spending a significant amount of money on entertainment and a retirement fund and failed to aggressively pursue the child support obligations of her husband. The court found followed the Brunner test in determining that she (1) did not show by a preponderance of the evidence that she could not maintain a minimal standard of living if forced to repay the loans; (2) did not show that she was in a dire financial situation certain to remain hopeless for the foreseeable future; and (3) did not make a showing of good faith effort to pay.<sup>27</sup> The court was not opposed to giving a partial discharge, but found that under these circumstances, the debtor could make lifestyle changes that would make it possible to repay the loans<sup>28</sup>. While the court sympathized with the fact that she would be paying her loans off until in her 70s, the circumstances were not so troubling to require a discharge<sup>29</sup>.

In *Krieger v. Education Credit Management Corp.*, however, the Seventh Circuit found that a debtor satisfied the *Brunner* test where she was not working and had not held a steady job in over a decade.<sup>30</sup> The court in this case found that the 52-year-old debtor, who was living with her 75-year-old mother, was in a hopeless situation.<sup>31</sup> The two women, living together, barely had enough money for car repairs, and could not manage to pay an extra dollar per month to the student loan creditor.<sup>32</sup> After applying for over 200 jobs over a decade to no avail, the court found that she was not a viable job candidate and would likely receive no offers within her field as a paralegal, or otherwise, in the foreseeable future.<sup>33</sup> Further, the debtor showed good faith

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<sup>26</sup> See *In re Shirzadi*, 269 B.R. 664, 672 (Bankr. S.D. Ind. 2001).

<sup>27</sup> *Id.*

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

<sup>29</sup> *Id.*

<sup>30</sup> See *Krieger v. Educ. Credit Mgmt. Corp.*, 713 F.3d 882, 885 (7th Cir. 2013).

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

effort to repay since she paid a portion of the loan off with her divorce settlement of over \$25,000.<sup>34</sup>

#### **IV. Implications**

It is extremely difficult to get a discharge either in whole or in part even today. It is hardly surprising that in 2007, 99.9 percent of debtors with student loan debt did not even try to discharge their student loan debt.<sup>35</sup> However, in 2007, bankruptcy courts granted a full or partial discharge to nearly forty percent of the 0.1 percent of the debtors who sought a hardship discharge.<sup>36</sup> These figures are consistent with the recent opinions, since the courts are more willing to fully or partially discharge a debt where there is little to no chance the debtor will ever have the ability to repay. However, this could just be the self-regulation of debtors' by counsel who only select the best cases for this issue.

Further, even though courts may be willing to allow a debtor (even one with a good salary) to at least partially discharge her student loan debt, they do not provide a windfall for the debtors because the debtor will still have to make sacrifices to make large monthly payments towards the remaining student loan debt. Ultimately, while these courts grant the debtor a partial reprieve from crushing student loan debt, the court simultaneously leaves the debtor with enough debt that the debtor would still need to adjust her expenses and lifestyle in order to make the payments.

#### **Conclusion**

Whether a debtor will be able to discharge student loan debt may depend on which test the court applies. First under the Totality of the Circumstances Test, a court will consider (1) the

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<sup>34</sup> *Id.*

<sup>35</sup> Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard*, 86 AM. BANKR. L.J. 495, 523 (2012).

<sup>36</sup> *Id.*

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>37</sup>

Next, the *In re Johnson* Test comprises of a mechanical examination, a good faith examination and a policy examination.<sup>38</sup> For the mechanical examination, the court considers whether the debtor can achieve standard of living above the poverty line over the longest possible lifetime of the loan while repaying the loan.<sup>39</sup> The good faith examination requires the court to inquire as to (1) whether the debtor was negligent in her efforts to maximize income and minimize expenses, and (2) if yes, would the mechanical examination be altered if no negligence were found.<sup>40</sup> Finally, for the policy examination, the court asks whether the circumstances demonstrate that the primary purpose of the bankruptcy was to discharge this type of debt or whether the debtor has benefitted financially from the education, which the loan financed.<sup>41</sup>

Finally, under the *Brunner* Test, the most restrictive test, a court will determine (1) whether “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) whether “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,” (3) whether “the debtor has made good faith efforts to repay the loans.”<sup>42</sup>

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<sup>37</sup> See Long v. Educational Credit Management Corp. (*In re Long*), 322 F.3d 549 (8th Cir. 2003).

<sup>38</sup> See *In re Johnson*, 5 Bankr.Ct.Dec. 532 (Bankr. E.D. Pa. 1979).

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

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

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

<sup>42</sup> See *Brunner*, 831 F.2d at 396.

Regardless of which test is applied, a court may discharge a debt in part or in whole. As such, a debtor may receive partial relief if she can only realistically repay a portion of her debt or total relief if she cannot realistically repay any of her debt.