Testimony of

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BEFORE THE COMMITTEE ON THE JUDICIARY,
SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW,
OF THE UNITED STATES HOUSE OF REPRESENTATIVES

Regarding

"HEARING ON AN UNDUE HARDSHIP? DISCHARGING EDUCATIONAL DEBT IN BANKRUPTCY"

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Chairman Conyers, Chairman Cohen, Ranking Member Franks and other distinguished members of the Subcommittee, thank you for the opportunity to testify before you today regarding the undue hardship discharge for educational loans in bankruptcy.

My name is Douglas Cuthbertson. I am an attorney engaged in the private practice of law in McLean, Virginia. I am a principal with the law firm of Miles & Stockbridge. I practice commercial and business litigation, and specifically, I represent financial institutions in consumer finance litigation in federal court. In my practice, I represent student lenders, servicers, collectors and federal guaranty agencies in a wide variety of litigation matters. I also represent secured and unsecured creditors in adversary proceedings in bankruptcy cases. I am counsel for the National Council of Higher Education Loan Programs, Inc. and several guaranty agencies under the Federal Family Education Loan Program ("FFELP") as *amici curiae* in support of the Petition for Writ of *Certiorari* in the case of *United Student Aid Funds, Inc. v. Espinosa*, which is pending before the Supreme Court.

I have been asked to appear before you today to testify about the effectiveness of the undue hardship discharge for educational loans as it currently exists under the Bankruptcy Code. My testimony is that of a practicing attorney; I am not appearing before you today on behalf of a client or in a representative capacity.

The exception to discharge for educational loans is one of many exceptions in the Bankruptcy Code to the general goal of a "fresh start" for debtors. Congress created these exceptions to the general rule of dischargeability because it believed that the creditors' interest in recovering full payment of debts in these categories outweighs the debtors' interest in a complete fresh start.

The exception to discharge for educational loans is codified at 11 U.S.C. § 523(a)(8). Congress enacted the exception in the 1970s in response to bankruptcies in which recent graduates filed for relief based primarily on student loan debt. The nondischargeability provision has two goals: (1) maintaining the financial integrity of the student loan system; and (2) curbing abuse by recent graduates, who have their whole lives of earning capacity before them.

One reason for the exception was the underwriting criteria of student lenders. Historically, student lenders have underwritten and funded private educational loans looking toward the student's future earning capacity as a source of repayment. Lenders making FFELP loans have no true underwriting criteria. With some exceptions, if a student is enrolled in a degree-granting program of an approved educational institution, he or she can receive a FFELP loan up to the maximum amount. In contrast, lenders that make other commercial and personal loans generally look to a borrower's current ability to repay and the value of collateral (such a car or a house) securing the loan. Neither of these criteria is present in most educational loans.

The Congressional purposes of maintaining the financial integrity and preventing abuses of the student loan system apply equally to both FFELP loans and private loans. Without the undue hardship standard, borrowers could enjoy the benefits of their education and file bankruptcy without ever attempting to repay, leaving lenders with no assets or other way to get repaid. Essentially, borrowers would be converting a student loan (whether FFELP or private) into a scholarship. With respect to private loans, removing the exception to discharge would have one of three effects: (1) lenders would decide to no longer make private loans—a real concern in this credit environment; (2) private loan lenders would increase interest rates or insist on a co-borrower; or (3) borrowers could chose to take out private loans rather than FFELP loans with the intent to discharge all of the loans after graduation. In other words, students may have a motivation to take out a higher cost private loan over a lower cost FFELP loan, thus damaging the integrity of the educational loan system.

Moreover, abrogating the exception to discharge for educational loans would be unfair to student lenders. Lenders who have served in the FFEL program have put their capital and work into the program predicated on the existing limitations on dischargeability. The same is true of lenders making private sector loans. These limitations have, in turn, been leaked into the pricing structure for securitizations, or at least no allowance has been made for dischargeability features in respect of these securitizations.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") amended Section 523(a)(8) to include an exception to discharge for "qualified education loans." The definition of qualified education loan includes most, but not all, private student loans. Thus, Congress treated FFELP and private loans the same. Private loans generally supplement FFELP loans. But due to the rapidly rising cost of higher education, private loans are an important source of educational funding for students. Removing the undue hardship standard for private loans would increase the cost of private student loans and decrease access to higher education.

Congress did not define "undue hardship," which has led to reliance on judicial interpretation. As a result, there is a well-developed body of law on this issue. The grounds for an undue hardship generally include illness, incapacity, extraordinary medical expenses, very low income and provisions for dependents. The key is not whether these factors exist, but the level they need to reach before they become "undue."

As with any factually intensive inquiry in our system of civil litigation, the trier of fact—here, a bankruptcy judge—is best situated to decide the issue of whether a student loan debt is an undue hardship on a debtor in light of the particular circumstances of each case. Courts have not required debtors to live at the poverty level in order to discharge their student loans. They also take into account a debtor's good faith effort to repay his or her student loans. Because of the factually intensive nature of the inquiry, in some cases, debtors are granted a discharge, and in others, they are not. But that is how Congress wrote the law, and the courts are obligated to follow it. Congress may give further direction reforming the undue hardship standard to ensure that it is being applied in a uniform manner in bankruptcy courts throughout the country. But the substantial body of law that has been developed in this area has proven to be workable and effective in preserving Congress' balanced goals of hardship discharge, while giving debtors a fresh start in bankruptcy.

The Second Circuit adopted the most widely accepted test in *Brunner v. New York State Higher Educ. Serv. Corp. (In re Brunner)*, 831 F.2d 395 (2d Cir. 1987). The *Brunner* test requires a debtor to show that: (1) the debtor cannot maintain a minimal standard of living and repay the loans; (2) exceptional circumstances exist that show that the debtor will not be able to repay the loans for a significant portion of the repayment period; and (3) the debtor has made a good faith effort to repay the loans. The *Brunner* test is the majority rule.

Under the *Brunner* test, courts evaluate debtors' current income and expenses to determine whether they can repay their student loans while maintaining an acceptable standard of living. Debtors must show that they are actively minimizing their current expenses and maximizing their personal resources. This requires a review of the reasonableness of the expenses budgeted by the debtor and an inquiry into his or her efforts to secure employment. Many courts look to the United States Department of Health and Human Services Poverty Guidelines to establish a base line for "minimal standard of living." But the guidelines are not determinative. Courts have allowed debtors with income in excess of the poverty level to discharge their student loans. In doing so, the courts have stated that Congress did not intend that a fresh start under the Bankruptcy Code means that families have to live at the poverty level.

Debtors also must show that there is something exceptional that makes their situation likely to persist. This requirement reflects the goal that students should not be able to discharge student loan obligations immediately upon graduation because they have their whole earning lives ahead of them. Generally, debtors' income increases over time. Debtors seeking a discharge must demonstrate a unique misfortune, disability or disadvantage—such as lack of job skills, lack of available jobs, and physical or mental disabilities—to show that their situations will not improve in the future. The required hardship must be more than the usual hardship that accompanies bankruptcy. Every debtor in bankruptcy has financial hardship—the question is whether it rises to the level of "undue" hardship.

It is not an undue hardship if a debtor is, and always will be, unable to find employment in his or her chosen field. The analysis does not focus on the debtor's ability to make good career choices, but rather on his or her ability to make a living in any field. The courts have stated that student lenders do not insure the value of an education.

Finally, student loan debt is not dischargeable unless the debtor can show that he or she has made a good faith effort to repay the loan. The debtor's own actions should not contribute to his or her inability to repay his loans. Things like buying a new car, sending children to expensive private schools, repaying other dischargeable loans, failing to negotiate payments before seeking a discharge and filing a petition too soon after completing the education may tend to evidence a lack of good faith. On the other hand, requesting a deferment or consolidating loans shows a good faith effort to repay. The case law shows an emphasis not necessarily on actual payments made, but on efforts to address the obligation.

Importantly, for today's hearing, debtors who are unable to pay loans originated in the federal student loan programs are not without redress for an overburdening set of economic circumstances occasioned by student loan debt load. There are various forms of borrower benefits relating to income, health and public service that allow borrowers to mitigate the effects of student loan debt. The most recent of these is Income-Based Repayment, established to provide borrowers within the FFELP program a way to make lowered payments.

Applying current law to the facts in an exercise of sound judicial discretion, bankruptcy judges can best determine whether loan debt is an undue hardship on a debtor in light of the particular circumstances of each case. In contrast to a process where a bankruptcy judge makes a careful assessment of undue hardship, some courts have recently ruled on the issue of whether debtors can effectively discharge student loans merely by completing a confirmed Chapter 13 plan containing discharge language. Some courts have held that language attempting to discharge student loans in this manner is sanctionable. Others have held that the appropriate vehicle for determining the dischargeability of student loans is an adversary proceeding.

This issue is before the Supreme Court in the case of *United Student Aid Funds, Inc. v. Espinosa*. In that case, the Ninth Circuit adopted a rule allowing discharge-by-declaration, *i.e.*, discharge of student loan debt in bankruptcy through a declaration of discharge in a Chapter 13 plan, if the creditor does not object to the plan, without requiring proof of undue hardship in an adversary proceeding. The administration has filed an *amicus* brief in *Espinosa*, supporting the creditor's position that the bankruptcy court's discharge order did not discharge Espinosa's student loan debt.

Removing the exception to discharge for educational loans would tighten credit, decrease access to education, reduce responsibility and accountability, and drive lending into the public sector. As a result, Congress instead should focus its efforts on taking action to help reduce rising educational costs and increasing post-graduation employment.

Thank you for holding this hearing and for the opportunity to appear before you today.