Polk County Bar Association
June 21, 2013

Bankruptcy Update

DISCHARGE OF STUDENT LOAN DEBT

1. STATUTE

A discharge . . . does not discharge an individual from any debt –
unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependent for –

- an education benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
- an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
- any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual

2. APPLICABLE STANDARD IN THE EIGHTH CIRCUIT

Long v. Educ. Credit Mgmt. Corp. (In re Long), established that the "totality-of-the-circumstances" test is to be used in this Circuit to determine whether an undue hardship exists which would support a discharge of student loan obligations under 11 USC §523(a)(8). In applying this standard, courts should consider:

(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.

322 F.3d 549, 544 (8th Cir. 2003). Further guidance as to the application of these factors is stated in the opinion as follows:

if the debtor's reasonable future financial resources will sufficiently cover payment of the student loan debt – while still allowing for a minimal standard of living – then the debt should not be discharged. Certainly, this determination will require a special consideration of the debtor's present employment and financial situation – including assets, expenses, and earnings – along with the prospect of future changes – positive or adverse – in the debtor's financial position.

3. CASE LAW

a. Student loans not discharged for undue hardship

In re Nielsen, Case No. 09-04888-als7, Adv. No. 10-30015-als, 2012 Bankr. LEXIS 807, at *7-8 (Bankr. S.D. Iowa Feb. 28, 2012), aff'd, 473 B.R. 755 (B.A.P. 8th Cir. 2012), aff'd, 502 Fed. Appx. 634 (8th Cir. Apr. 25, 2013).

In re Nielsen, Case No. 09-04888-als7, Adv. No. 10-30016-als, Adv. No. 10-30018-als, 2013 WL 2299626 (Bankr. S.D. Iowa May 24, 2013).

Chapter 7 debtors, Erik and Katherine Nielsen, filed three adversary proceedings seeking discharge of their student loan obligations under an undue hardship theory pursuant to 11 U.S.C. section 523(a)(8). In two separate proceedings, the court held that the debtors' student loans were not discharged. Kathryn Nielsen had an MBA, but she stated that she had been unsuccessful in obtaining employment and planned to stay home with her children and home school them for the next 18 years. Her husband, Erik Nielsen held an associate's degree, and was employed outside of the home full time. Despite Kathryn Nielsen's much higher earning potential, the debtors determined that she would stay home and raise the children. Kathryn Nielsen testified that she had had difficulty finding employment in their small community because of a lack of suitable job opportunities, but both debtors testified they were unable to move because of the modifications they had made to their home to maintain a mold-free environment. The debtors attempted to show that they had an ongoing medical hardship because of mold allergies, but the debtors were unable to substantiate their claims. The court considered the totality of the circumstances including the debtors' past, present and future financial resources, reasonable living expenses, and additional factors such as the debtors' health, the availability of an income contingent repayment plan of $0, the debtors' concern about potential future taxes, and the debtors' efforts to repay the loan. The court concluded that the debtors had not shown an undue hardship.

Erik Nielsen's case was decided first, and he appealed it to the B.A.P. On appeal, the B.A.P. affirmed the bankruptcy court holding that there was no error in the court's analysis of the debtor's past, present and reasonably reliable future financial resources. The B.A.P. also found that there was no error in finding that the Nielsens are were able to maintain a basic standard of living. The B.A.P. found no error in the bankruptcy court's

finding that the medical records did not support any sort of ongoing treatment or orders with respect to mold and that the ICRP was a viable avenue for repayment.

The Eighth Circuit, in an unpublished per curiam decision, affirmed the B.A.P. The Eighth Circuit. held that the court did not err in finding that Nielsen's allergies did not restrict his ability to work and that Nielsen failed to establish his student loan debt was dischargeable based on undue hardship. The Eighth Circuit also held that there was no error in the bankruptcy court considering Nielsen's eligibility for the Income Contingent Repayment Program as one factor in its analysis.

Educ. Credit Mgmt. Corp. v. Jesperson, 571 F.3d 775, 779 (8th Cir. 2009).

In this case the court considered evidence submitted by ECMC regarding how much payments would be under an Income Contingent Repayment Plan and compared those payments to the debtor's expenses. The Jesperson court also stated, "[a] debtor is not entitled to an undue hardship discharge of student loan debts when his current income is the result of self-imposed limitations, rather than lack of job skills." The Debtor was a recently licensed attory attempting to get his student loans discharged. At the time of trial, he owed ECMC $304,463.62 in principal, interest, and collection costs on eighteen student loans, and he owed Arrow Financial Services $58,755.26 on seven other student loans. He had never repaid any part of any loan. After passing the bar, Jesperson worked as a judicial clerk, then as an attorney, and then as a legal temporary. He quit both of these jobs for a variety of personal reasons. Then he worked with a placement agency on a project paying $25 per hour. The court held that Jesperson's young age, good health, number of degrees, marketable skills, and lack of substantial obligations to dependents or mental or physical impairments weigh in favor of not granting an undue hardship discharge. Id. at 780. The court stated that the only reason he has a colorable claim of undue hardship is the sheer magnitude of his student loan debts. "While the size of student loan debts relative to the debtor's financial condition is relevant, this should rarely be a determining factor."

> It would be perverse to allow the debtor to benefit from [his] own inaction, delay and recalcitrance by automatically granting discharge simply because the debt is a sizeable one. This, of course, would benefit those who delay and obstruct the longest and could encourage other students to follow the [same] course.

Id. at 780 (citing United States v. Kephart, 170 B.R. 787, 792 (W.D.N.Y. 1994)). The Jesperson court considered the possibility of the debtor entering into an income contingent repayment plan and the court stated that "[w]hen the size of the debt is the principal basis for a claim of undue hardship, the generous repayment plans Congress authorized . . . under the William D. Ford Federal Direct Student Loan Program become more relevant to a totality of the circumstances undue hardship analysis." "[T]he ICRP is a factor to consider in evaluating the totality of the debtor's circumstances. However, a

student loan should not be discharged when the debtor has the ability to earn sufficient income to make student loan payments under the various special opportunities made available through the student loan program." Additionally, the court stated, "[a] debtor is not entitled to an undue hardship discharge of student loan debts when his current income is the result of self-imposed limitations, rather than lack of job skills, and he has not made payments on his student loan debt despite the ability to do so." Id. at 782.

Long v. Educ. Credit Mgmt. Corp. (In re Long) 322 F.3d 549, 544 (8th Cir. 2003)

Debtor was a 39-year-old single mother who had financed her education at Northwestern College of Chiropractic with substantial student loans. She operated a successful chiropractic practice from 1990 until 1993 when she began to experience extreme fatigue, depression, and diminution of her mental faculties. In 1995, she terminated her chiropractic practice and continued in a downward economic and emotional spiral. Id. at 551. She earned $1,163 per month and lived at her parents' home. To treat her condition, she took various prescription drugs and slept in excess of 12 hours per day. At the time of trial she owed $61,000 to ECMC and $15,000 of a separate, non-dischargeable Health Education Assistance Loan. ECMC urged her to consider the ICRP. She acknowledged that she knew about it but did not apply because "she believed that she could not handle things and because her circumstances continued to be overwhelming." Id. at 552. The Eighth Circuit remanded the case to the BAP but reaffirmed that the test in the Eighth Circuit is the totality of the circumstances.

On remand, the BAP concluded that the Debtor would not suffer an undue hardship if required to repay the loans under the income Contingent Repayment Plan. 292 B.R. 635, 638-39 (B.A.P. 8th Cir. 2003). The court held that the Debtor's income potential should increase in the future, because she was currently on a regimen of medication which enabled her to work and pursue an additional degree at the same time. The BAP concluded that the Debtor's monthly income exceeded her monthly expenses and her surplus income was sufficient to cover her monthly ICRP payment. Id.

In re Sederlund, 440 B.R. 168 (B.A.P. 8th Cir. 2010).

The debtor had financed her Bachelor of Arts degree in Psychology with student loans. The loans totaled approximately $47,000 at the time of trial. The debtor was a 42-year-old woman with no dependents. The debtor never obtained employment in her field of study but held several jobs at law firms and with the food service industry. She lives with her boyfriend who paid more than half of their household expenses. Id. at 170-71. While the debtor's income was consistently below the poverty line, the court held that this did not support a finding of undue hardship because her boyfriend's contributions to the household expenses were a relevant factor and the debtor was voluntarily underemployed. "A debtor is not entitled to an undue hardship discharge of student loan debts when his current income is the result of self-imposed limitations, rather than lack of

job skills." Id. at 174 (citing In re Jesperson, 571 F.3d at 782. The court also considered the ICRP for which the debtor would qualify and under which the debtor would owe a payment of zero. The debtor stated that she had not applied for this program because of the tax consequences. The court held, "while there is some question as to whether borrowers whose student loans are forgiven are subject to tax liability, the Eighth Circuit in Jesperson appeared to reject the argument that such potential tax liability is a basis for a finding of undue hardship under § 523(a)(8)." Id. (citing Jesperson, 571 F.3d at 782.).

In In re May, 368 B.R. 850, 853-54 (Bankr. D. Neb. 2007).

Debtor was a 36-year-old attorney with two bachelor's degrees, an MBA and a JD, was single with no dependents and employed full-time as an associate at a law firm. At the time of trial the debtor owed over $264,770. The debtor was enrolled in the ICRP which required a monthly payment of $611.30. Id. at 855. The debtor testified that she could not make payments on her current salary of $47,000 and that she had asked for pay increases and has looked for different jobs but has been unsuccessful. She was limited to living and working in the geographic area of eastern Nebraska because she regularly visited and assisted her widowed mother, who lives nearby. The debtor testified to having several chronic health issues. The debtor had no disposable income based on her income and expenses. The court held that the undue hardship test should be applied to each loan individually and that the debtor's ability to pay should be reviewed chronologically, with the oldest loan being analyzed first. Id. at 858-59. Additionally, there was a finding by the court that the debtor had led a fairly extravagant lifestyle, could increase her income, has not minimized her expenses and has not made any real effort to repay the loans. The debtor did not suffer from any disability or other condition that prevented her from achieving her full earning potential, and with two advanced degrees it was likely that debtor had the ability to earn substantially greater income in the future.

b. Student loans discharged based upon undue hardship

In re Walker, 650 F.3d 1227, 1229 (8th Cir. 2011).

The Eighth Circuit affirmed the discharge of the roughly $300,000 of debtor's student loans. The debtor completed her undergraduate degree and two years of medical school when she failed her state licensing exam and was dismissed. Afterwards, she worked as a pharmacy technician and substitute teacher. After getting married she entered a master's program and graduated with a degree in school psychology. The debtor worked for the school district at a full-time post-graduate internship until her position was cut. Id. at 1229. After her internship ended, the debtor cared for her five children, including twins with autism. The twins were involved in a state-funded program which required a parent to be present for in-home therapy sessions of eight-nineteen hours during the week plus eight hours each Saturday and Sunday. The debtor also had difficulty keeping a regular schedule because she needed to be available to respond to calls from the school if either of the autistic twins had a "meltdown." Id. at 1230. The debtor and her husband had taken out a $50,000 home equity loan to build a screened-in deck and purchased a

suburban for $40,000. The debtor would have a monthly payment of $593.98 under an ICRP. Id. The Eighth Circuit held that the bankruptcy court properly considered the debtor's financial condition for the years 2004 through 2007 in the undue hardship analysis and the bankruptcy court did not speculate or make assumptions. Id. at 1231-32. In addition, the porch and the car fulfilled important functions in the family's daily life, and even if the family had not made those expenditures, they still would not have been able to meet the monthly ICRP payment.

In Re Shaffer, Bankr. No. 10-01926-als7, Adv. No. 10-30109-als, 2011 WL 6010240 (Bankr. S.D. Iowa Dec. 1, 2011), aff'd 481 B.R. 15 (B.A.P. 8th Cir. 2012).

Chapter 7 debtor filed a complaint seeking discharge of her student loan obligations held by three different lenders under an undue hardship theory. The debtor was an unmarried woman in her mid-thirties with no dependents. The debtor suffered from mental health issues including eating disorders, depression, self-harm (cutting), and anxiety, which adversely affected her academic endeavors and her ability to maintain employment. The debtor attended two different schools and earned her bachelor of arts degree. She then enrolled in a few community college classes in order to maintain her coverage under her parents' health insurance. She subsequently enrolled at the Palmer College of Chiropractic Medicine. She attended chiropractic school for a little over a year until she left school without completing her degree. Id. at *17. To fund her education, the debtor obtained student loans totaling approximately $202,525. The court granted a discharge of the debtor's student loan obligations. The court considered the debtor's past, present and future financial resources, reasonable living expenses and other relevant circumstances, including the debtor's mental health and found that the debtor's current expenses were modest, she had minimal disposable income and a diagnosed mental illness. The court held that the debtor's income limitations were not self-imposed and that based on her education and employment history, the debtor did not have the ability to make payments on her student loans and maintain a minimal standard of living.

The B.A.P. affirmed the bankruptcy court's decision and held that the debtor's past spending habits and history of living beyond her means did not mean the bankruptcy court was required to find that the debtor could afford to make payments on her loans in the future. The B.A.P. also held that the bankruptcy court's finding that the debtor's income limitations were not self-imposed was not clearly erroneous. Finally, the B.A.P. held that the court did not need expert testimony on the debtor's depression and mental health issues.

In re Lee, 352 B.R. 91 (B.A.P. 8th Cir. 2006)

Debtor was 31 years old with $47,612.11 of student loans. The debtor was the custodial parent of two children. The court notes that the record was sparse with regard to the debtor's health but that it is uncontroverted that she would need to undergo an unspecified surgical procedure in the near future. The debtor earned $9.00 an hour and

her gross monthly income was $1,132. She was also eligible for an ICRP which would require a payment of $13.03 a month for a maximum of 300 months. The debtor had never made a payment on her student loans. The Debtor had reasonable monthly expenses and her expenses exceed her income by $214. The trial court found that the debtor did not have the skills or the experience to earn significantly more than the $10.50 per hour that she was making. She was tied to El Dorado, Arkansas, where her family provides her with childcare. "Her prospects might be brighter if she moved to a bigger city, but the additional income would likely be offset by increased housing and childcare costs." Id. at 95. The BAP found no error in the bankruptcy court's conclusion that the debtor could not afford the $13.03 per month payment and that excepting the loans from discharge would be an undue hardship. The creditor in this case argued that the court did not sufficiently consider the ICRP option. The BAP held that the creditor had overstated the weight due the ICRP under the totality of the circumstances test. The BAP stated that "[p]lacing too much weight on the ICRP would have the effect in many cases of displacing the individualized determination of undue hardship mandated by Congress in section 523(a)(8) since the payments on a student loan will almost always be affordable. . . . But the Debtor's current and prospective ability to pay, while important, is not the only consideration under the totality of circumstances test." Id. at 95-96. The BAP also pointed out the difference between the ICRP and the undue hardship inquiry. "Under the ICRP, a debtor is presumed to have the ability to pay 20% of the difference between her adjusted gross income and the poverty level for her family, or the amount the debtor would pay if the debt were repaid in twelve years, whichever is less." Id. at 96. A bankruptcy court, on the other hand, "engages in a case-by-case analysis of a debtor's income in relation to her reasonable expenses." Id. Additionally, the ICRP serves a different goal than the Bankruptcy Code. The ICRP's goal is "to assist borrowers in avoiding default." Id. The Bankruptcy Code's goal is to "provide a fresh start to honest but unfortunate debtors." Id. The Code provides a way to obtain a discharge of student loan debts and "the ICRP cannot be allowed to foreclose that avenue."

In re Cumberworth, 347 B.R. 652 (B.A.P. 8th Cir. 2006).

Debtor had $34,000 in student loan debt. She made payments for five years until she defaulted. Shortly after, she negotiated an income contingent repayment plan whereby she paid $208 per month. She made payments under this plan for three more years until she was notified by the DOE that they were reviewing her case and requested the debtor to provide information concerning her financial situation. The DOE claimed that the debtor failed to provide it with all the financial information it requested and demanded that the debtor begin making regular monthly payments of $580 per month. By the time the debtor filed the case, the principal balance on the student loans including penalties and accrued interest was $64,233.89. The Debtor had back surgery that failed and she was determined to be 100% permanently disabled. Her husband is also 100% permanently disabled. Their income is fixed in disability and social security. The bankruptcy court determined that the debtor has discretionary income of only $70 per month while her monthly payment on the student loans is $580 per month. Additionally, she tried to lower the monthly payment but failed to reach an agreement and made a good

faith effort to repay the student loans while she was employed. The BAP upheld the Bankruptcy court's determination that the debt was dischargeable under these circumstances.

In In re Ford, 269 B.R. 673, 675-66 (B.A.P. 8th Cir. 2001).

Debtor, a 62-year old single woman with no dependents, owed over $73,000 in student loan debt. She suffered from arthritis and was only able to perform work for four or five hours a day. She had a monthly income of $1,338. Her monthly expenses totaled $1,338. The court found that her income was not likely to increase, her expenses were reasonable, and that the other factors, such as her age and her disability all weighed in favor of her loans being discharged. Additionally, the court found that a 25-year ICRP plan is unrealistic because she would be 87 years old before she would be relieved of the burden of the student loans.

In re Brooks, 406 B.R. 382 (Bankr. D. Minn. 2009).

This 48 year old divorced debtor had three children, only one of which lived at home. The debtor has been diagnosed with alcohol dependence, depression, post-traumatic stress disorder, and irritable bowel syndrome. The Social Security Administration determined the debtor disabled. The debtor was employed at different jobs but for various reasons, including alcoholic relapses, left the employment. She also enrolled in a graduate degree program to earn a master's degree and did not finish. Id. at 386. The court held that the debtor's mental illnesses present fundamental obstacles to obtaining and maintaining a job. The ICRP available to the debtor is $43.86 per month. At the end of the 25 years, the debtor would be 73 years old. Id. at 388. The court held that because of the drawbacks to the ICRP, including the continual accrual of interest, the debtor would have an insurmountable tax burden after the 25 year repayment period and has no monthly surplus to make the ICRP payments.

In re Fahrer, 308 B.R. 27, (Bankr. W.D. Mo. 2004).

The debtor had taken out loans in the amount of $104,128 to finance a career in the ministry. At the time of trial, the interest on the loan had grown to $180,196.15. The debtor was 53 years old and had not been able to work full time because she needed to be home to take care of her husband's physical needs. He had heart problems, high blood pressure, diabetes, kidney problems, depression, anxiety disorder and prostate cancer. The debtor's income was from her husband's disability payments from the Social

Security Administration and from the Veteran's Administration and from her substitute teaching. Their combined monthly income was approximately $3,769. Debtor claimed expenses of $4,198.78 per month. In 1997 and 1998 Debtor made some payments on the loan. Id. at 32. When the court considered the debtor's past, present and future financial resources, it found that the debtor's ability to earn outside the home was limited because of her spouse's needs. The court also considered that under the ICRP, the debtor would not be required to make monthly payments on the loan. The court said that the Debtor opting not to apply for participation in the ICRP was a factor that weighed against the discharge of the loans. However, the fact that the debtor would be faced with a large taxable income at the end of the 25 repayment years, when the debtor was 78 years old, in essence, requiring the debtor to participate in an extended repayment plan which significantly exceeds the debtor's working life, constitutes an undue hardship. Id. at 35-36. The court also took into consideration the psychological and emotional impact of the Debtor's continuing liability for the repayment of such a large sum of money over an extended period of time. Id. at 36. The court held that under these circumstances the repayment of the debt would be an undue hardship.

In re Korhonen, 296 B.R. 492 (Bankr. D. Minn. 2003).

The 42-year old, homeless debtor owed over $110,000 in student loans. The debtor had academic problems and was diagnosed with attention deficit disorder and emotional distancing. He was unable to complete the course work required for graduation and withdrew from school. Id. at 494. He held a series of jobs. He sustained a knee injury and a stress fracture and problems with his left ankle. He applied for Social Security disability benefits, and the SSA determined that he suffered from a severe impairment but he did not meet the required impairments for disability. The ICRP would require him to pay nothing toward his student loans each month. Id. at 496. The court held that even with the ICRP's payment of nothing, the loans represent an undue hardship because they will never be repaid and would "haunt him for twenty five years and then create an income liability he could not pay." Id.