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CRS Report for Congress

Student Loans in Bankruptcy

Duke Chen
Law Clerk
American Law Division

Summary

Currently, student loans cannot be discharged when the debtor declares bankruptcy, which means that, unlike most other unsecured debt, student loans will stay with the debtor post-bankruptcy. There are two bills pending before the 110th Congress that would amend the U.S. Bankruptcy Code to restore limited dischargeability for student loans, consistent with the law at various points in its prior history.

If enacted, S. 511 would make both public and private loans dischargeable in bankruptcy when seven years have passed from the beginning of the repayment period. Another bill, S. 1561, would eliminate privately financed student loans from those that are nondischargeable in bankruptcy. The purpose of the bill would be to restore the law to its status before the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) in 2005.

This report examines the history of student loan nondischargeability in bankruptcy law and the bills introduced to amend treatment of loans in bankruptcy.[1]

Introduction. Currently, student loans cannot be discharged when a debtor files for bankruptcy under the U.S. Bankruptcy Code, 11 U.S.C. § 101 *et seq.*, which means that, unlike most other unsecured debt, student loans will stay with the debtor post-bankruptcy.[2] Prior to 1976, educational debt was completely dischargeable, but with the enactment of the code in 1978, governmental student loans were made conditionally dischargeable. Over the years, the scope of student loan dischargeability has been steadily narrowed. Despite the trend toward nondischargeability, some have questioned whether a policy of full nondischargeability is necessary or appropriate. Two bills have been introduced which would allow limited dischargeability for specified student loans. This report surveys the history of student loan nondischargeability and pending bills to amend the U.S. Bankruptcy Code.

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[1] This report was prepared under the general supervision of Robin Jeweler, Legislative Attorney.

[2] 11 U.S.C. § 523(a)(8)(2005).

Sixty-two percent of full time undergraduates receive aid, either from federal or state governments, the institutions which they attend, employers, or other private sources.[3] Public loans,[4] more specifically federal student loan programs, are the single most important source of financial aid for students.[5] There are many types of federal loan programs, each with its own set of qualifications and requirements.[6] Likewise, there are differences between a federal student loan and its private counterpart. Even though both loans are dispersed by private lenders, federal loans are insured against borrower default by the federal government.[7] Also, federal loan interest is capped at a maximum interest rate set by statute.[8] In addition to the limits to interest rates, the law also limits how much a student can borrow.[9] But, because federal loan programs have not kept pace with the escalating costs of attending schools of higher learning,[10] increasingly more students also look to private loans to finance part of their education.[11] The private loan industry is able

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[3] There has been a 35% increase in the average tuition and fees for in-state students attending public universities since 2001-2002, which amounts to the greatest increase for any five-year period over the last 30 years. Even though private school tuition increases have been lower, their overall expenses still greatly exceed their public counterparts. The average annual tuition and fees at a four-year public college or university in 2006-2007 is $5,836, compared to the average annual tuition and fees at a four-year private college or university being $22,218. *Trends in College Pricing,* 2006 TRENDS IN HIGHER EDUCATION SERIES (CollegeBoard), at 4, *available at* [http://www.collegeboard.com/prod_downloads/press/cost06/trends_college_pricing_06.pdf]. *Id.*at 2.

[4] Public loans or governmental loans that are mentioned in this report refer to loans made under any program funded in whole or in part by any governmental entity, including states. There is an emphasis placed on federal loans because the majority of governmental loans come from the federal government.

[5] For a more detailed explanation of the various federal financial aid programs, see CRS Report RL33673, *Federal Family Education Loan Program Student Loans: Terms and Conditions for Borrowers,* by Adam Stoll. See also CRS Report RL31618, *Campus Based Student Financial Aid Programs Under the Higher Education Act,* by David P. Smole.

[6] Some examples of federal loans include Stafford loans, both subsidized and unsubsidized, as well as the PLUS loans, which are available to parents of dependent undergraduates and to graduate students.

[7] See CRS Report RL33673, *Federal Family Education Loan Program Student Loans: Terms and Conditions for Borrowers,* by Adam Stoll. In addition to guaranteeing the loans, the federal government also provides lenders various incentives to ensure enough capital will be available for student loans. *Id.*

[8] P.L. 107-139, 116 Stat. 8 (2002). The interest rate on new Stafford Loans dispersed after July 1, 2006, is a fixed rate of 6.8%. The interest rate on new PLUS Loans dispersed after July 1, 2006, is a fixed rate of 8.5%. See CRS Report RL33673, *Federal Family Education Loan Program Student Loans: Terms and Conditions for Borrowers,* by Adam Stoll.

[9] The total amount may vary depending on the program and eligibility of the student. See CRS Report RL33673, *Federal Family Education Loan Program Student Loans: Terms and Conditions for Borrowers,* by Adam Stoll.

[10] *Trends in Student Aid,* 2006 TRENDS IN HIGHER EDUCATION SERIES (CollegeBoard), at 2, *available at* [http://www.collegeboard.com/prod_downloads/press/cost06/trends_aid_06.pdf].

[11] In the 1994 school year, private loans equaled 5% of the federal student loan volume; by 2006,

(continued...)

to set interest rates as the markets dictate, which, depending on the individual student, can reportedly reach rates as high as 20%.[12]

Consequently, as the number of students who graduate with debt has increased along with their debt burden,[13] so have questions as to whether these student loans should be dischargeable, in whole or in part, in bankruptcy.

Legislative History of Student Loans in Bankruptcy. Prior to 1976, educational debt was dischargeable in bankruptcy.[14] In 1970, Congress established the Commission on the Bankruptcy Laws of the United States (Commission) to analyze the bankruptcy system and to make recommendations for reform.[15] In 1973, the Commission issued its report and recommended prohibiting student loan discharge of governmental loans until five years had passed after the beginning of the repayment period, except in cases in which it would cause undue hardship[16] for the debtors or their dependents.[17] In 1976, Congress adopted these recommendations when it amended the Higher Education Act of 1965 by adding Section 439A, which included an amendment to the bankruptcy laws with governmental student loans being nondischargeable.[18]

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[11] (...continued)
private loans were up to 25%, totaled $17.3 billion a year, and grew at an average annual rate of 27% from 2000-2006. *Trends in Student Aid* at 5.

[12] Diana Jean Schemo, *Private Loans Deepen a Crisis in Student Debt*, N.Y. TIMES, June 10, 2007.

[13] *See* 153 CONG. REC. S1711 (2007) (statement of Sen. Clinton). In 1993, less than half of college students graduated with debt, but now two-thirds leave with some form of debt. *Id.* The median amount of student debt for 2003-2004 graduates is $19,300. It should be noted that more precise data is not available since the 2003-2004 term, though it is almost certain that the debt levels have increased. *Student Debt: Students Relying More Heavily on Private Lenders*, 2006 TRENDS IN HIGHER EDUCATION SERIES (CollegeBoard), *available at* [http://www.collegeboard.com/prod_downloads/press/cost06/student_debt_06.pdf].

[14] *See* 11 U.S.C. § 35(a)(1976)(repealed 1978).

[15] P.L. 91-354, 84 Stat. 468 (1970).

[16] Undue hardship has not been statutorily defined; it has instead been a court defined term. Though there has not been a uniform ruling as to what constitutes "undue hardship," most of the courts use a three-pronged analysis known as the *Brunner* test. The *Brunner* test is as follows:

> [to establish undue hardship the debtor must show] (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependants 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.

Brunner v. New York State Higher Edu. Serv. Corp., 831 F.2d 395, 396 (2d Cir. 1987). For more information on what constitutes "undue hardship," and other tests that the minority of the courts use, see Robert F. Salvin, *Student Loans, Bankruptcy, and the Fresh Start Policy: Must Debtors be Impoverished to Discharge Educational Loans?* 71 TUL. LAW REV. 139 (1996).

[17] H.R. DOC. NO. 93-137, pt. 2, at 136 (1973).

[18] *See* Education Amendments of 1976, P.L. 94-482, §127(a), 90 Stat. 2081, 2141 (codified at (continued...)

Section 439A did not take effect immediately.[19] Congress delayed the effective date for nearly a year in order to assess the results of a General Accounting Office (GAO) study of federally insured and guaranteed student loans.[20] Another reason for the delay was to allow Congress time to consider legislation to effect major reform to the bankruptcy system.[21]

Before Section 439A took effect, the House Judiciary Committee reported a bill to reform the bankruptcy laws and an accompanying report to the full House.[22] The proposed legislation would have repealed Section 439A and reinstated the dischargeability of educational loans.[23] However, the Judiciary Committee's attempt to undo Section 439A did not succeed; when the House considered the bankruptcy bill, an amendment was proposed on the floor to preserve the status of educational debt as passed in Section 439A.[24] With speeches warning about the lack of funds for future students and other equally bleak scenarios,[25] the amendment passed by voice vote and the nondischargeable status of governmental educational debt was once again restored.[26] Once the bill arrived in the Senate, there was little discussion about the educational debt portion, which became 11 U.S.C. § 523(a)(8).[27]

In 1990, Congress amended § 523(a)(8) to further curtail governmental student loan dischargeability. This was accomplished by lengthening the five-year bar to seven years.[28] Although another congressionally mandated Bankruptcy Review Commission

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[18] (...continued)
20 U.S.C § 1087-3 (1976)) *repealed by* Bankruptcy Reform Act of 1978, P.L. 95-598, § 316, 92 Stat. 2549, 2678.

[19] Rafael I. Pardo and Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge Educational Debt*, 74 CIN. L. REV. 405, 422 (2005).

[20] *Guaranteed Student Loan Program Bankruptcies* (GAO-HRD-77-83, April 1977).

[21] Rafael I. Pardo and Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge Educational Debt*, 74 CIN. L. REV. 422 (2005).

[22] This bill, H.8200, 95th Cong., 2nd sess. (1978) was ultimately enacted as the Bankruptcy Reform Act of 1978, which repealed the Bankruptcy Act of 1898 and became the basis for the modern bankruptcy code. CRS Report 97-1057, *A Bankruptcy Primer: Liquidation and Reorganization Under the U.S. Bankruptcy Code*, by Robin Jeweler.

[23] H.Rept. 95-595 at 132 (1977). The House Report stated that Section 439A was targeting a perceived problem rather than a real one and that less than 1% of all federally insured and guaranteed educational loans were discharged in bankruptcy. The House Report came to the conclusion that anecdotal evidence of a few serious debtors caused the movement for educational loans to be nondischargeable in bankruptcy. *See id.* at 133.

[24] 124 CONG. REC. 1783, 1792 (1978).

[25] *See id.*

[26] *Id.* at 1798.

[27] *See* S.Rept. 95-989, at 79 (1978). *See also* 124 CONG. REC. 33,998.

[28] *See* Crime Control Act of 1990, P.L. 101-647, 3621, 104 Stat. 4789(1990).

recommended permitting dischargeability of student loans,[29] § 523(a)(8) was once again amended in 1998; the seven-year bar was eliminated so that governmental student loans could never be discharged, absent a showing of undue hardship.[30] Then in 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) which amended § 523(a)(8) to make private educational loans nondischargeable, when in the past it had only applied to governmental loans.[31] As a result of BAPCPA, the current state of bankruptcy law as it pertains to student loans is that both private and public student loans are nondischargeable in personal bankruptcy absent a showing of undue hardship.

Rationales for Making Student Loans Nondischargeable. The reason most often cited for making student loans nondischargeable is to prevent fraud. The legislative history of the 1978 Bankruptcy Reform Act contains warnings that making student loans dischargeable would be "almost specifically designed to encourage fraud."[32] There was the fear that students would discharge their debt and then be able to spend their earnings on other items instead of paying off what they owed.[33]

Another argument is that student loans are different from other loans, and as such, should be treated differently.[34] Under this view, a college degree is an asset which should bar debtors from discharging loans that were used to procure it.[35] Also under this view, student loan recipients are generally younger and will have more working years to repay their debts.[36]

Rationales for Making Student Loans Dischargeable. The reason most often cited for making student debt dischargeable is that educational debt should be treated like any other unsecured debt, which is dischargeable in bankruptcy.[37] The argument is, student loans should be treated more similarly to regular unsecured debt than to such obligations as child support payments, alimony, overdue taxes, and criminal fines, all of which are nondischargeable in bankruptcy.

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[29] National Bankruptcy Review Commission Report, at 207 (established pursuant to the Bankruptcy Reform Act of 1994, P.L. 103-394)(October 20, 1997). The 1997 report recommended that Congress eliminate § 523(a)(8) to be "consistent with federal policy to encourage educational endeavors." *Id* at 216.

[30] *See* Higher Education Amendments of 1998, § 971, P.L. 105-244, 112 Stat. 1581, 1837 (1998).

[31] P.L. 109-8, § 220, 119 Stat. 23 (2005). When BAPCPA was enacted, Congress once again failed to adopt the recommendations of the National Bankruptcy Review Commission to repeal the nondischargeability of student loans.

[32] H.Rept. 95-595, at 536 (statement of Rep. Ertel).

[33] *Id.*

[34] Deanne Loonin, *No Way Out: Student Loans, Financial Distress, and the Need for Policy Reform*, National Consumer Law Center, at 33, *available at* [http://www.consumerlaw.org/news/content/nowayout.pdf].

[35] *Id.*

[36] John A.E. Pottow, *The Nondischargeability of Student Loans in Personal Bankruptcy Proceedings: the Search for a Theory*, 44 CANADIAN BUS. LAW J. 245, 254 (2006).

[37] National Bankruptcy Review Commission Report, at 207.

Another argument is that the fear of abuse of the system is unfounded because bankruptcy abuse is minimal. In response to the assertion that if student loans were dischargeable, there would be massive fraud, the 1997 Bankruptcy Commission found in its report that there was no evidence to support the assertion that when student loans were dischargeable the bankruptcy system was "systematically abused."[38]

Legislation Introduced in 110th Congress to amend § 523(a)(8). *S. 511, 110th Congress, 1st sess. (2007) entitled "A bill to provide student borrowers with basic rights, including the right to timely information about their loans and the right to make fair and reasonable loan payments, and for other purposes."* If enacted, S. 511 would make both public and private loans dischargeable in bankruptcy after seven years have passed from the beginning of the repayment period. It is important to note that this bill only acts prospectively and only applies to loans that are made subsequent to the passage of S. 511. It would not work retroactively to make loans that were made in the past dischargeable.

S. 1561, 110th Congress, 1st sess. (2007) entitled "A bill to amend title 11, United States Code, with respect to exceptions to discharge in bankruptcy for certain qualified educational loans." If enacted, S. 1561 would eliminate privately financed student loans from those that are nondischargeable in bankruptcy. The purpose of the bill would be to restore the law to its status before the passage of BAPCPA in 2005 by making only government-financed (and non-profit) educational loans and benefits nondischargeable. The legislation would result in private lenders being treated as other creditors holding unsecured debt, which means they would not receive preferential treatment in bankruptcy.[39]

In making a distinction between public and private loans, the reasoning for not including the publicly funded student loans is that they are backed by taxpayer dollars; therefore, the borrowers should not be able to discharge publicly funded debt because, in a sense, they owe the taxpayers a duty when they are loaned this money in their pursuit of an education.[40]

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[38] National Bankruptcy Review Commission Report, at 214.

[39] *See 153* CONG. REC. S7335 (2007) (statement of Sen. Durbin).

[40] *Id.*