Written Response of Edward Janger to the Questions for the Record of Kamala Harris and Amy Klobuchar

Hearing of the Subcommittee on Oversight, Agency Action, Federal Rights, and Federal Courts "Small Business Bankruptcy: Assessing the System" held March 7, 2018

This memo is in response to the questions of Senators Kamala Harris and Amy Klobuchar with regard to the non-dischargeability of student loans in Bankruptcy under 11 USC 523(a)(8), and of Senator Klobuchar with regard to the priority of wages and pension plan contributions under 11 USC 507(a)(4) and (5) of the Bankruptcy Code.

Student Loans

Your first question relates to student loans. As I explained in my oral testimony, student loans are intended to help middle class Americans gain the skills and expertise necessary to succeed in the modern economic environment. Non-dischargeability is based on the questionable assumption that making student loan debt harder to discharge will reduce the credit cost of these loans. Given that many of these loans are guaranteed by the federal government, this assumption is questionable. Furthermore, the strategy is regressive, saddling the borrowers most in need of educational loans with an inescapable debt load if their attempt at upward mobility fails. As I will discuss below, the current standard for discharging student loans in bankruptcy is both outdated and far too harsh. The views I will articulate here are consistent with those stated by the Consumer Committee of the American Bankruptcy Institute, available here: https://abiworld.app.box.com/s/3t5yc6n0kkz2z3lfldbwqxk3igirk11r.

It must be noted at the outset that there *are* legitimate reasons for treating student loan differently from other debts. Students often emerge from school in straightened economic circumstances. School is expensive, and their careers are just getting started. But this distress is often temporary, as their incomes will hopefully increase over time. Allowing an immediate discharge may, in some cases, allow graduates with high income prospects to shed student debt, when, if given time, they would be able to repay. This, however, does not justify the current treatment of such loans.

The history of the student loan discharge provisions in the Bankruptcy Code explains why the current discharge standard is miscalibrated; the current legal standard was adopted to apply to a very different statute. In 1978, the first version of 11 U.S.C. 507(a)(8) granted non-dischargeability only to government loans, and allowed for discharge after 5 years, or if repayment would constitute an "undue hardship."[1] Over time, Congress repeatedly amended Section 507(a)(8) to make discharging student loans harder, while extending this preferred treatment to a wider variety of loans. In 1990, the length of time to dischargeability was

[1] P.L. 95-598, Nov. 6 1978. Pub. L. No. 95-598 (11/6/1978).

extended to 7 years.[2] And then in 1998, the waiting period was eliminated entirely, leaving only discharge based on undue hardship.[3] Meanwhile, non-dischargeabilty was made available to some private loans in 1994,[4] and then expanded to cover all private loans in 2005.[5]

The key point is that the current majority test for "undue hardship" was formulated in 1987, at a time when loans could be discharged after 5 years. That standard was stated by the 2nd Circuit in *Brunner v. New York State Higher Education Services Corp.* as follows:[6]

> (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.

This standard is quite rigorous, but when formulated, it only ever applied to situations where a debtor was trying to discharge student loan debt within 5 years. In such a circumstance an exacting test might be expected. However, once the statute was amended in 1998, undue hardship became the only route to a discharge. At that point, the *Brunner* test became applicable not just to debtors seeking an early discharge, but also to debtors who had been unable to repay their loans for an extended period of time. Notwithstanding the history, most courts have continued to insist on a high standard for discharge. A somewhat more liberal "totality of the circumstances" test was adopted by the 8th Circuit after 1998.[7] That test allows the court to consider the debtor's financial resources and reasonable living expenses when judging undue hardship. That test is stated as follows:

> 1) the debtor's past and present financial resources and those the debtor can reasonably rely on in the future, 2) the reasonable necessary living expenses of the debtor and the debtor's dependents, and 3) any other relevant facts and circumstances surrounding each particular bankruptcy case.

This test is an improvement, but it is not universally followed, and the *Brunner* test remains the majority rule.

In light of this history, there are a number of positive legislative steps that might be taken to properly calibrate the standard for student loan discharge.

- One possibility might be to return to the law prior to 1994 and reinstate the dischargeability of student loans after 5 or 7 years.

[2] Pub. L. No. 101-647, 104 Stat. 4789 (11/29/1990).

[3] Health Professions Education Partnerships Act of 1998, Pub. L. No. 105-392, 112 Stat. 3524 (11/13/1998).

[4] Pub. L. No. 98-353, 98 Stat. 333 (7/10/1994).

[5] Pub. L. No. 109-8 (10/17/2005).

[6] *Brunner v. New York State Higher Educ. Servs. Corp*., 831 F.2d 395, 396 (2dCir.1987).

[7] *Long v. Educ. Credit Mgmt.* (In re Long), 322 F.3d 549, 554-55 (8th Cir. 2003).

- Second, the "undue hardship" standard could be revised to mandate the "totality of the circumstances" standard followed by the 8th Circuit. That standard allows the court to look at past, present, and predictable future income, and the living expenses of the debtor's dependents and consider whether they will be able to maintain a reasonable standard of living while repaying their student loan debt.
- Third, the statute might be amended to allow for a partial discharge, in appropriate cases, where loan repayments would be set at a level that committed disposable income for a period similar to that of a Chapter 13 plan, while allowing the debtor a reasonable standard of living.

Any of these steps would be an improvement, and all could play a role in a revised statute.

Another important step that should be taken would be to allow separate classification of student loans in Chapter 13 plans. When a debtor is seeking to implement a repayment plan under Chapter 13, the debtor may not separately classify student loan debt. [8] This makes it difficult for the debtor to make substantial reductions in their student loan balance during the Chapter 13 case. If student loan payments receive the same payments as other unsecured creditors under the Plan, the debtor may not be able to make a substantial reduction in their student loan indebtedness. Thus, even at the end of their chapter 13 plan, they may exit bankruptcy with their student loan debt undiminished. This also may prevent a Chapter 13 debtor from taking advantage of a variety of federal loan forgiveness plans, such as Income-Based Repayment (IBR), Pay As You Earn (PAYE), Revised Pay As You Earn (REPAYE), and Income-Contingent Repayment.[9]

- So, fourth, Chapter 13 should be amended so that if a debtor is currently participating in one of the existing student loan forgiveness programs, the payments under that plan could be separately classified and included in the Chapter 13 budget as necessary expenses.

Finally, a question has been raised as to the practical effects that such changes might have on the market for student loans. Here, it is important to recognize that there are two sectors to the student loan market. Government loans and government guaranteed loans on the one hand, and private loans on the other. Where government issued, or guaranteed loans are involved, there will be little effect on the cost of loans to students, as the guaranty will protect the lender. It is possible that this will increase the cost of these programs to the government. However, it is important not to overstate the effect. Declaring a loan non-dischargeable does not guaranty that it will be repaid. A debtor in financial distress cannot make payments with money he or she does not have. Therefore, the effect will, in large measure, be simply to cause the government to recognize that certain loans are going to be non-collectible, or not collectible in full. Some of the approaches detailed above, may actually increase the ultimate

[8] 11 USC 1322(a)(3).

[9] https://studentaid.ed.gov/sa/repay-loans/understand/plans.

realization on defaulted loans. For example, a partial discharge that allows a debtor to restructure its student loan debt, and to maintain a realistic (albeit somewhat reduced) payment schedule may actually cause a debtor to restart payments at a maintainable level rather than giving up altogether. Where private loans are concerned, this might lead to an increase in the interest charged on these loans, but that might be an appropriate tradeoff for the ability to discharge the loans in bankruptcy.

In sum, there are a variety of ways of reforming the current approach to student loans. Perhaps the simplest might be just to go back to the law as of 1994, to make loans dischargeable if they have been due for more than 7 years, and in cases of undue hardship, but any of the suggestions made above would be a significant improvement.

Wage Priority and Pension Plan Contributions Under 11 USC 507

Your second question relates to whether it is desirable to increase the size of the priority for wage claims and pension plan contributions in Bankruptcy cases. Section 507 of the Bankruptcy Code grants a priority to employee wage claims of up to $12,850 that accrue within the six months prior to bankruptcy. This is a very limited priority for employees. Indeed, it is even more limited than it seems at first glance. As a practical matter this priority protects only an employee's pay and retirement benefits for the last pay period before bankruptcy. The reason for this is that, even though the lookback period is 180 days, very few employees continue to work after their employer has stopped making payroll. Thus, the priority amount is largely determined by an employee's income, not by the statutory cap or the lookback period.

For example, if an employee is paid monthly, and is paid $12,850, a full month's pay of an employee making $154,200 will be protected, as will the employee's pension benefit contribution. Increasing the wage priority would simply extend the protection to more highly compensated employees. It would not benefit less highly compensated employees whose wages do not exhaust the statutory cap.

This creates a puzzle, is there a way to increase the protection of employees, while targeting employees on the lower end of the wage distribution. There is a creative solution to this problem. Where an employee's wages in the last pay period do not exhaust the $12,850 cap, the balance may be made up with vacation, sick leave and severance benefits that accrue within the six months prior to bankruptcy. For an employee who accrues 4 months of vacation a year, that would add another two weeks' worth of wages, up to the cap. For an employee who accrues 2 weeks' worth of severance per year, that would add one week of severance (again subject to the cap). Therefore, if there is a desire to increase the priority available to employees whose base wages do not exhaust the statutory cap, the best approach might be to create a separate priority category and a separate cap for vacation pay, sick leave and earned severance. This would increase the amount entitled to priority for all employees, not those just with higher salaries.

I hope these answers are helpful, and look forward to any further questions you might have.