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Legal Sidebar

How Hard Should it be to Discharge a Student Loan in Bankruptcy?

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In recent years, many Americans have found themselves increasingly unable to repay their student loans. Ordinarily, a debtor who cannot afford to pay his debts may potentially "discharge"—that is, obtain relief from—many of those debts by filing for bankruptcy. The federal Bankruptcy Code, however, limits the circumstances in which a debtor may discharge a student loan through the bankruptcy process. As explained in greater detail below, a debtor may generally not discharge a student loan in bankruptcy unless he can prove that repaying the debt would impose an "undue hardship" on the debtor and his dependents—a term that many courts have interpreted to permit a discharge of student loans in narrow circumstances only.

Several Members of the 115th Congress have introduced a variety of bills in response to criticisms that existing bankruptcy law makes it too difficult for debtors to obtain relief from their student loans. This Sidebar accordingly analyzes the treatment of student loans under existing bankruptcy law before surveying a selection of bills that, if enacted, would alter the legal standards governing whether and when a debtor may discharge student loan debts. A separate CRS product discusses the treatment of student loans in bankruptcy in greater depth.

Bankruptcy and Student Loans

The federal Bankruptcy Code attempts to balance several competing policy concerns. On the one hand, the bankruptcy system aims to give honest debtors a "fresh start"—that is, to grant debtors relief from debts they cannot repay. This fresh start generally comes in the form of a "discharge" of many of the debtor's debts, which generally consists of a legal right not to pay the discharged debts as well as safeguards against future harassment by the creditor whose debt is discharged. In exchange for receiving this discharge, a consumer debtor must generally distribute a portion of his assets or income to his creditors to the extent the debtor has the financial ability to satisfy their claims in whole or in part.

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Beyond merely seeking to provide relief to debtors, bankruptcy law also seeks to promote countervailing interests, such as maximizing total creditor return. One of several ways that the Bankruptcy Code attempts to balance these competing interests is by making certain types of debts presumptively or categorically nondischargeable. "Congress has decided" that, in some circumstances, "public policy considerations override the need to provide the debtor with a fresh start." As relevant here, and as explained in significantly greater detail in a separate CRS product, Section 523(a)(8) of the Bankruptcy Code sharply limits the circumstances in which a debtor may discharge a student loan through the bankruptcy process. With extremely limited and technical exceptions, a debtor may not discharge a student loan unless he proves that excepting the loan from discharge "would impose an undue hardship on the debtor and the debtor's dependents."

Several Members of the Congress that first enacted Section 523(a)(8) offered multiple policy justifications for treating student loans differently from other types of consumer debt—many of which are typically freely dischargeable in bankruptcy. First, Section 523(a)(8)'s sponsors sought to preserve the financial vitality of the student loan program so that funds remained available for future students to finance their educations. Secondly, student loans have significantly different characteristics than certain other common forms of consumer debt, like home mortgages and car loans. Whereas a debt collector may repossess and resell a house at auction if a homeowner fails to pay his mortgage, there is no comparable way to repossess someone's education. Supporters of Section 523(a)(8) therefore concluded that this distinction from other forms of consumer debt supported treating student loans less favorably in bankruptcy. Finally, Section 523(a)(8)'s sponsors sought to address the concern that students would abuse the student loan program. If student loans were freely dischargeable in bankruptcy, students might strategically avoid paying their student loans by declaring bankruptcy immediately after graduation, when they have the highest debt load and the fewest assets to distribute to creditors. Such students could then reap all the economic and intellectual benefits of a postsecondary degree while "making the taxpayers pick up the tab."

Significantly, while Section 523(a)(8) prohibits debtors from discharging student loans unless they can prove an "undue hardship," Section 523(a)(8) does not expressly define what an "undue hardship" is. Nor has the Supreme Court articulated a controlling interpretation of that statutory phrase. As a result, different federal courts have interpreted the "undue hardship" standard differently. Most (but not all) require the debtor to prove that:

1. He could not maintain a "minimal" standard of living for himself and his dependents if he were forced to repay his student loans;
2. His inability to repay the loans is likely to persist into the future; and
3. He has made good faith efforts to repay the loans.

The relatively open-ended and "fact intensive" nature of this legal standard has resulted in numerous doctrinal splits between the federal courts regarding when a debtor is entitled to an undue hardship discharge. Some critics of the undue hardship standard, citing what they characterize as "the haphazard fashion in which courts have determined whether a debtor's circumstances support a claim of undue hardship that warrants forgiveness of educational debt," have contended that "the vagueness of section 523(a)(8) fosters litigation and inconsistency of results." Apart from criticisms concerning whether Section 523(a)(8)'s text provides courts with sufficient interpretive guidance for determining whether any given debtor may validly discharge a student loan, some have also claimed that the undue hardship standard makes it too difficult for debtors to obtain relief from their educational debts.

Legislative Proposals Pending in the 115th Congress

Responding to criticisms regarding the current treatment of student loans in bankruptcy, Members of the 115th Congress have introduced several bills that propose to amend Section 523(a)(8) in a variety of ways. To name just a few examples, several bills propose to make student loans freely dischargeable in bankruptcy like most other consumer debts, without requiring the debtor to prove an undue hardship. Other bills would make *privately* issued student loans freely dischargeable, but leave the treatment of *federal* student loans unchanged.

As explained below, however, one of the newer bills pending in the 115th Congress takes a slightly different tack. Notably, the Bankruptcy Code has not always required debtors to demonstrate an undue hardship as a prerequisite for discharging a student loan. As originally enacted, Section 523(a)(8) gave debtors two different options for discharging a student loan: the debtor could either (1) satisfy the undue hardship standard; or (2) wait to file bankruptcy until five years after the student loan first became due. Thus, from 1978 until 1990, student loans that first became due over five years before the debtor filed for bankruptcy were freely dischargeable through the bankruptcy process, no matter whether repaying those loans would amount to an undue hardship. Commentators referred to this latter option for discharging a student loan as the "time lapse discharge" or "temporal discharge" option. In 1990, however, Congress narrowed the scope of the time lapse discharge option by increasing the five-year period to seven years. Congress then eliminated the time lapse discharge option entirely when it enacted the Higher Education Amendments of 1998 (HEA). The legislative history of the Amendments reflects that Congress opted to eliminate the time lapse discharge in order "to ensure the budget neutrality of" the HEA. Thus, under current law, proving an undue hardship is effectively the only way that a debtor may discharge a student loan through the bankruptcy process.

Several commentators have advocated amending the Bankruptcy Code to revive the time lapse discharge option—that is, to allow debtors to freely discharge student loans that first became due several years before the debtor filed for bankruptcy without demonstrating an undue hardship. Supporters of the time lapse discharge option emphasize that Congress initially enacted Section 523(a)(8) to prevent debtors from abusing the student loan program by filing for bankruptcy immediately after graduation. A debtor who waits several years before filing for bankruptcy, however, is arguably less likely to be abusing the student loan program. Supporters also argue that a debtor who waits several years before seeking to discharge his student loans is likely to have greater income or assets than a recent graduate who has just entered the workforce, which could be used to partially satisfy the debtor's outstanding student loan debt before discharging the remainder that the debtor is unable to repay.

The Student Loan Bankruptcy Act of 2018 (H.R. 6588) (SLBA) was introduced in the House of Representatives on July 26, 2018 in response to calls to reinstate the time-lapse discharge option. If enacted, the SLBA would allow debtors to discharge a student loan in bankruptcy—without proving an undue hardship—if the loan "first became due more than 5 years . . . before the date" the debtor filed for bankruptcy. The SLBA would thereby make it easier for debtors to discharge federal and private student loans alike. Moreover, by narrowing the universe of cases in which a court must decide whether the debtor has adequately demonstrated an "undue hardship," the SLBA could potentially mitigate the aforementioned doctrinal confusion regarding how courts should interpret that undefined phrase. On the other side of the ledger, however, the SLBA could adversely affect the financial interests of student loan creditors—which include the federal government—by prohibiting those creditors from collecting debts they might otherwise be able to recover. Notably, the SLBA would be prospective in effect only—the SLBA states that it "shall not apply with respect to any debt for an educational benefit, overpayment, loan, scholarship, or stipend received by a debtor before the effective date of th[e] Act," and shall not take effect until "1 year after the date of . . . enactment." Potential justifications for restricting retroactive application of the SLBA could include reducing the act's impact on the federal budget and avoiding interference with the expectations of existing creditors. As of the date of this writing, the SLBA is presently pending before the House Committee on the Judiciary.