Discharging Student Loans in Bankruptcy Proceedings May Now Be Possible for Some People

June 17, 2013 - In two separate rulings, and in two separate federal circuits, appeals courts have now allowed the discharge of federally backed student loans in two bankruptcy cases. The two rulings, which took place in the Seventh and Ninth federal circuits, are narrow but will likely apply in more cases.

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Federal student loans are the one form of debt that can't typically be discharged in bankruptcy. The reasoning behind this is that the loans are backed by taxpayer money and taxpayers shouldn't be left on the hook for these loans. In fact, those who default on federal student loans while they are still working could easily find that their Social Security benefits are garnished when they retire. It is simply a bad idea to stop making payments on federal student loans.

In cases of bankruptcy, the law requires that borrowers make a good faith effort to repay their loans. That typically means that bankruptcy judges will require filers to enroll in an income based repayment plan (also known as an IBR). But the courts are starting to carve out exceptions based on certain criteria known as the Brunner Test.

The Brunner Test is a three point test the courts use to evaluate a borrower's ability to repay. Under Point 1, the borrower must show that given their current income and expenses they can't maintain even a basic standard of living if they are forced to repay. Under Point 2, they need to show that the conditions in Point 1 are not likely to change anytime soon and that they have no reasonable expectation of ever being able to repay the debt. And under Point 3, they need to show that they have made a good faith effort to repay the debt.

Point 3 has turned out to be the most important factor in cases involving federal student loans. Lenders have contended that in order for someone to meet the "good faith" requirement in the Brunner Test, any borrower who is offered and IBR must agree to enroll in it. If the debtor doesn't agree to enroll, then they are not making a good faith effort. But the recent ruling carved out exceptions.

In both cases, the debtors involved were older; 53 and 64 respectively. And in both cases, the debtors had incurred significant debt by going to law school. In the case of the 53 year old, the court found that the debtor was "destitute". In the second case, the debtor was in poor heal and would have had to participate in the IBR until he was 89 years old.

Based on the rulings, it is highly unlikely that any appeals court would allow a younger debtor who is able to work to discharge her or her student loan debt through bankruptcy. But there are millions of older Americans who incurred student loan debt of their own and who are now approaching retirement age. Others who have become permanently disabled or who face significant medical challenges. People in these situations may now be able to have their student loans forgiven if they can meet the challenges laid down in the Brunner Test.

byJim Malmberg
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