MISCONCEPTIONS & MUDDIED WATERS: ARE STUDENT LOAN DISCHARGE STANDARDS ANY CLEARER?

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Two recent decisions in our circuit may have offered the first "break" for student loan debtors in years. In April, the Ninth Circuit BAP issued *In re Roth,* 490 BR 908 (9th Cir BAP 2013). In May, the Ninth Circuit Court of Appeals decided a case I've worked on for years, *Hedlund v. Educational Resources Inst., Inc.,* 718 F3d 848 (9th Cir 2013).

Both decisions allowed debtors to discharge student loan debt. *Roth* reversed a bankruptcy court's denial of discharge in a case involving a 64-year old unemployed debtor with health problems and Social Security income of less than $800 per month; the debtor had failed to make voluntary payments, failed to apply for or obtain any forbearances, and failed to apply for the income-based-repayment plan (IBRP), which required annual reporting and projected payments of $0 per year for 25 years. In *Hedlund*, the Ninth Circuit upheld a bankruptcy court's discharge of approximately $50,000 out of $85,000 in principal on a student loan for a healthy 33-year old debtor who had failed the bar exam three times, and had provided evidence that his full-time employment was at or near the highest he could earn in his area (and that moving to obtain higher paying work would be offset by higher cost of living); he had made only one voluntary payment, and refused to accept repayment options that he could not have afforded on the eve of trial.

The *Hedlund* and *Roth* decisions both turned on a concept that may be uninteresting to anyone but an appellate lawyer – the appropriate standard of review. To understand whether *Hedlund* and *Roth* signal a sweeping change in student loan discharge cases, it is important to examine their precursors.

As ably described in Judge Pappas's *Roth* concurrence, student loan "undue hardship" discharge has been subject to the three-part *Brunner* test for over 25 years. *Brunner v. New York State Higher Educ. Serv. Corp.*, 831 F2d 395 (2d Cir 1987). The *Brunner* case, adopted by the Ninth Circuit in *In re Pena,* 155 F3d 1108 (9th Cir 1998), addressed the student loan discharge exception in 11 USC §523, which, at that time, required debtors to prove undue hardship to except any student loan debt that was less than five years old. It adopted the following test for undue hardship:

> (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; and (3) that the debtor has made good faith efforts to repay the loans.

Brunner, 831 F2d at 396. In *Brunner*, the debtor sought to discharge $9,000 in student loans in a bankruptcy filed after only a few months of unemployment following expiration of the grace period for repayment of her loans. The Second Circuit concluded that the debtor, who did not file a brief on appeal, did not establish good faith. The court noted, "she is not disabled, nor elderly," had no dependents, had not established that her inability to find work would persist into a significant portion of the repayment period, and had not made sufficient efforts to repay her loans. *Id.* At 396-97.

When the Ninth Circuit adopted the *Brunner* test in *Pena* more than ten years later, it applied the test to very different facts: it held that a bankruptcy court **did not** clearly err in finding good faith where the debtor wife had a mental disability, the debtor husband's income was unlikely to increase, debtors had made payments until they were laid off from their jobs, and they filed bankruptcy only after a period of deferment ended. *Pena*, 155 F3d at 1114.

More recently, the Ninth Circuit held that the bankruptcy court **did** "clearly err" in finding good faith. *In re Mason*, 464 F3d 878 (9th Cir 2006). It reversed a grant of partial discharge (affirmed by the BAP) where a 33-year-old debtor with a learning disability had failed the bar exam after taking it one time (and without requesting special accommodation) and was employed part-time as a contractor. The court affirmed the bankruptcy court's holdings on the first two *Brunner* prongs. *Id*. at 882-84. It reversed on the good faith issue, however, noting the debtor failed to negotiate repayment options including the Income Contingent Repayment Plan (ICRP) available at the time, worked only part time, and took the bar exam only once before concluding it was hopeless. *Id*. at 885. The *Mason* court cited with approval the BAP's decision in *In re Biranne*, 287 BR 490, 499-500 (9th Cir BAP 2002), in which the BAP found lack of good faith where a debtor had only part-time employment and did not apply for the ICRP. If one were not to look beyond the outcomes, these decisions arguably discouraged student loan debtors from going to the expense of filing an adversary proceeding to seek discharge of their loans.

Another Ninth Circuit decision, *In re Nys*, 446 F3d 938 (9th Cir 2006), provides key background to the good faith issue that is central to the *Hedlund* and *Roth* decisions. The court in *Nys* remanded for additional findings on the second *Brunner* prong of "additional circumstances" showing the debtor's situation is likely to persist for a significant portion of the repayment period. It provided a 12-point "nonexhaustive" list of factors a court could consider, including serious mental or physical illness of the debtor or her dependents that prevents employment or advancement, debtor's obligation to care for dependents, lack of usable skills, age, and others. *Id.* at 947, citing with approval the BAP decision at 308 BR 436, 446-47 (9th Cir BAP 2004). Many of the facts that can establish the first and second *Brunner* prongs pop up again when courts get to the troublesome third *Brunner* prong, the good faith analysis. Thus *Nys* must be considered and addressed by those seeking discharge.

The recent media attention to the student loan debacle is not lost on the courts. Consider that *Brunner* involved $9,000 in debt while *Hedlund* involved one of two student loan debts of

$85,000, almost ten times that amount. The policy debate clearly influenced the district court decision in *Hedlund*. After addressing nationwide statistics on student loans and prospects for employment, the district court noted that

> the current higher education system has become untenable and unsustainable; as a result, increasing numbers of students will be forced to file for bankruptcy. As such, the student loan issue is one that extends beyond the outcome of this decision and will continue unabated until it is addressed at a systemic level. Bearing this in mind, the Court now turns to the issue of whether Hedlund's student loans are dischargeable.

Hedlund, 468 BR 901, 908 (D Or 2012), *rev'd*, 718 F3d 848 (9th Cir 2013). The court concluded:

> While this Court is dismayed by the circumstances faced by the majority of today's law school graduates, Hedlund's case is distinguishable. He graduated in 1997, which was a period of great prosperity and rapid economic growth for the United States.

468 BR at 916. The district court went on to find that the evidence Hedlund put on was insufficient to establish good faith, even going so far as to comment on his lifestyle "choice" of living as a single-income family and dropping a footnote to point out that Hedlund had made no payments during the nine years of the appellate process – but did not acknowledge that he had made payments to the other student loan lender with which he settled before the 2003 trial. *Id.* at 915- 16 & n.9.

The Ninth Circuit's decision in *Hedlund* is so important because its underlying message, in my view, is that the bankruptcy courts, which hear the testimony, see the presentation of the evidence, and scrutinize debtors' budgets on a daily basis in the thousands of consumer cases filed each year, are the ones best situated to make decisions about what is or is not good faith. National policy debates are better left for Congress. The *Hedlund* decision made clear that it is the deferential "clear error" standard of review that a reviewing court applies to a bankruptcy court's findings on good faith.

The *Roth* case, in contrast, applied the less deferential "de novo" standard in determining whether a debtor had established each *Brunner* prong, including good faith, to reverse a bankruptcy court ruling and find that the debtor **should** receive a student loan discharge. 490 BR at 914-15, 917-20. Judge Pappas wrote his concurring opinion, in part, because he understood "how the bankruptcy court felt restricted by precedent" in deciding that the 64-year-old debtor should not be discharged of student loan debt but should be required to sign up for the 25-year IBRP repayment plan and file annual reports showing payments of $0. *Id*. At 920. Judge Pappas urged the Ninth Circuit to revise the *Brunner* test and allow bankruptcy courts to consider the totality of a debtor's circumstances in deciding undue hardship cases. "And this hardship test," he continued, "would focus on the contemporary world of student debt, not circumstances that existed thirty or more years ago." *Id*. at 923.

Instead of examining the *Brunner* test itself, the Ninth Circuit in *Hedlund* focused on the standard of review for a bankruptcy court's application of the *Brunner* test. (I can report that no one briefed the issue of whether the *Brunner* test should be revised in the *Hedlund* appeal. This is perhaps because, seven years into the appeals process, the Ninth Circuit issued its initial decision remanding the case back to the bankruptcy court for more findings on the good faith prong. Why would the debtor risk anything other than trying to get the Ninth Circuit what it asked for – more findings?)

While *Hedlund* is certainly an encouraging decision (and, in my view, the right outcome for debtor who presented substantial evidence that he was the proverbial turnip from which no blood can be squeezed), it is debatable whether it provides the clarity student loan debtors (and their counsel, if they are lucky enough to afford counsel) seek. It is nearly impossible to boil down the decision to a few key facts sufficient to win a student loan discharge case. The decision does reaffirm, however, that some things are not absolute. For example, a debtor's failure to apply or sign up for the IBRP may not be fatal to a student loan discharge case. *Roth* is perhaps most encouraging on that front, finding that the debtor was not required to enroll in IBRP for 25 years with a projected payment of $0, file annual reports, and face "potentially disastrous" tax consequences, because "the law does not require a party to engage in futile acts." 490 BR at 920.

The media reports and inquiries I received after the *Hedlund* decision tell me that misconceptions persist about discharge of student loan debt in bankruptcy. Many of the reported decisions, like *Roth*, involve a *pro se* debtor or, as in *Hedlund*, pro bono counsel who agreed to assist and brief these important issues. These cases are not easy to bring or to win. I disagree with claims that a decision like *Hedlund* will "open the floodgates." The most important thing that the Ninth Circuit did in *Hedlund*, in my view, was to reaffirm the bankruptcy court's crucial role in making these determinations in the first instance. And the most important thing the bankruptcy court did was to consider the evidence and recognize the futility of holding the entire debt nondischargeable when there was no mathematical way Mr. Hedlund could ever repay.

The Ninth Circuit concluded *Hedlund* with this statement:

> In sum, even though some might disagree with the bankruptcy court's good faith finding, it was not clearly erroneous. The court relied on substantial evidence in the record, and its factual inferences were permissible.

718 F3d at 856. During the 10-year journey of this case up and down the appellate system, I read various characterizations of the evidence in the record. Some refused to look beyond the fact that, at the time of trial, Hedlund was in his 30s, healthy, and employed full-time. He was faulted for leasing a second car (a Honda Accord), for having two cell phones, and for not insisting that his wife work more than one or two days a week instead of staying home to care for their child. He was faulted for not accepting one of a number of repayment options; he was

given no credit for paying part of a small inheritance toward student loan debt and for not contesting garnishments for 16 months, until a second creditor began to garnish as well. I have seen comments about the taxpayers being asked to foot Hedlund's student loan bill – yet little or no concern about the taxpayers footing the bill for student loan lenders to pursue these cases when they will ultimately recover nothing even if they prevail.

At every stage of the *Hedlund* case that I was involved in – from the briefing on the remand before Judge Radcliffe and then, upon his untimely passing, the briefing and argument to Judge Brandt, then the briefing to the US District Court, and, finally, to assisting Hedlund's pro bono counsel in the Ninth Circuit – the phrase "you can't squeeze blood from a turnip" ran through my head. The Ninth Circuit's decision vindicated what the real issue in these cases can and must be – deference to a bankruptcy court's review of the evidence. Bankruptcy courts scrutinize income and expenses and put a debtor's lifestyle under the microscope every day. Who better to decide whether a debtor has met the undue hardship standard? If a bankruptcy judge finds that a debtor put on adequate evidence that there is no more blood to squeeze and never will be, why should that finding be disturbed absent "clear" error?

I imagine student loan cases are some of the most difficult for bankruptcy courts. In Hedlund's case, not one, but two bankruptcy judges reviewed the evidence. Neither concluded that Hedlund was entitled to a full discharge of his more than $85,000 in loans. Rather, each judge carefully calculated income and expenses to come up with an exact amount that Hedlund was able to repay. To arrive at that amount, both judges figured that Hedlund's wife could work a bit more (in a flower shop at little more than minimum wage) without unduly increasing childcare costs, and scrutinized, item by item, his modest living expenses – and attempted to predict and account for circumstances over the 25-year repayment period. I found their efforts Herculean and I am glad the Ninth Circuit finally vindicated those efforts.

As a parting note, I find it interesting that I believed in Mike Hedlund's case despite having made payments on my own student loans for nearly a decade. I'm not sure whether the *Brunner* test should be revisited. Judge Pappas's concurrence in *Roth* makes good points. For those wanting to pursue these cases and advise clients on them, what I hope the *Hedlund* decision shows is that they may be hard to win, but bankruptcy judges are the ones you need to prove your case to.