Testimony before the

U.S. Senate Judiciary Committee

"Student Loan Bankruptcy Reform"

August 3, 2021

Testimony submitted by:

Elizabeth Gonzalez

Directing Attorney, Consumer Law Unit

Public Law Center

PUBLIC LAW CENTER
Providing Access to Justice
For Orange County's Low Income Residents

601 Civic Center Drive West

Santa Ana, CA 92701

(714) 541-1010

www.publiclawcenter.org

Testimony of Elizabeth Gonzalez for the U.S. Senate Judiciary Committee

"Student Loan Bankruptcy Reform"

August 3, 2021

Chair Durbin, Ranking Member Grassley, members of the Committee, thank you for inviting me to testify today. My name is Elizabeth Gonzalez and I am the Directing Attorney for the Consumer Law Unit at the Public Law Center (PLC) in Santa Ana, California.

PLC is a 501(c)(3) legal services organization that is committed to providing access to justice for low income residents of Orange County, California. Generally speaking, our clients earn less than 400% of the federal poverty level, and many earn less than 125% of the federal poverty level. Our clients are diverse, and the majority are individuals of color. PLC provides direct legal services in seven substantive areas of law: Community Organizations Legal Assistance, Housing and Homelessness Prevention, Health Law, Family Law, Immigration, and Consumer Law.

Within the Consumer Law Unit, we house our bankruptcy project, through which we assist low-income debtors who are considering filing for Chapter 7 bankruptcy. PLC assists these debtors at our courthouse-based clinics, through in-house consultations and representation, and through the assistance of pro bono representation.

Since 2012, PLC has provided approximately 5,000 bankruptcy consultations to debtors through our bankruptcy work. These debtors are generally seeking to file for bankruptcy because unforeseen changes in their economic situations have made it impossible for them to pay their debt. For the most part, these individuals have tens of thousands of dollars of non-secured debt, which may include medical debt, credit card debt, and federal student loan debt.

Of these thousands of consultations, PLC has filed only five adversary proceedings to attempt to discharge federal student loans. To be clear, many other debtors could have benefitted if their federal student loans were discharged, but given the high bar of undue hardship, these other debtors would likely not have been successful in an adversary proceeding.

Sadly, those borrowers who were not able to file to discharge their student loans find themselves in a purgatory of sorts – they have a fresh start for most of their debt, but are still struggling to pay their student loans.

As I discuss further in my testimony, PLC advises low-income debtors on an array of non-bankruptcy options to try to address student debt, including income-driven repayment plans. While income-driven repayment programs help some borrowers, they don't help all of my clients. Some of them are not eligible for the programs. And others can't participate in the programs and still make ends meet. While many of my clients work-full time, the cost of living in Orange County is 87% higher than the national average, and its housing costs alone are 374% higher than the national average.[1] So, while an income-driven repayment program requires these clients and debtors to pay 10-15% of their discretionary income, discretionary income in Orange County is anything but. This income is necessary to pay rent, buy food, and pay for gas in an area where public transportation is challenging.

For my clients, bankruptcy is the option of last resort. But what I have learned from borrowers and bankruptcy practitioners is that the current system of how federal student loans are handled in bankruptcy is not working. Too many borrowers who find themselves in need of filing bankruptcy due to economic reasons are unable to obtain a fresh start because the debt that tends to be the largest, federal student loans, cannot be discharged in bankruptcy.

We all have to remind ourselves that the high bar of discharging student loans in bankruptcy did not always exist. Before the law was changed in 1998, borrowers were able to discharge their federal student loans in bankruptcy if they could either establish undue hardship *or* prove the loan first became due at least seven years before filing for bankruptcy.[2] There is nothing I have found to suggest that, before 1998, borrowers were rushing to file for bankruptcy seven years after their loans became due. As is discussed below, very few people rush to file for bankruptcy in general.

The removal of the temporal discharge option created a system that is not working. By limiting the discharge option only to those who can establish the high bar of undue hardship, borrowers who are facing massive debt while working and living paycheck to paycheck cannot have their loans discharged. As discussed below, this creates a situation where borrowers are unable to plan for their futures, they are unable to save for emergencies or retirement, and they are unable to purchase a home, support a family, or better their living situations.

What I have also learned from borrowers and bankruptcy practitioners is that the current system of how federal student loans are handled in bankruptcy is based on a flawed premise. The narrative that the bankruptcy courts and the federal student loan program will be overrun with students seeking to discharge their student loans in bankruptcy if the temporal discharge option is reinstated is a fiction. This did not happen before 1998, and in my experience, my clients do not want to file for bankruptcy if there is any way they can avoid it. However, the fact that lower-income borrowers are trapped in a cycle of poverty because they are unable to discharge their student loans in bankruptcy is very real and something I and PLC see far too often.

---

[1] Orange County Community Indicators 2020-2021, p. 109, https://www.ocbc.org/wp-content/uploads/2020/09/2020-Community-Indicators-Report.pdf

[2] P.L. 95-598, § 523(a)(8), 92 Stat. 2549 (1978); Crime Control Act of 1990, P.L. 101-647, § 3621(2), 104 Stat. 4789 (1990).

While PLC's work provides a very small snapshot of the needs of federal student loan borrowers, it is my hope that the testimony I provide today will help the committee better understand this issue from the experience of actual borrowers and bankruptcy practitioners.

Below, my testimony provides more details about the practical side of why student loan borrowers should have the option to discharge their student loans in bankruptcy. This testimony offers general background on (1) why individuals file for Chapter 7 bankruptcy; (2) the process of determining whether, under the current system, it is feasible for a borrower to have their student loans discharged, including whether existing programs provide borrowers relief outside of bankruptcy; and (3) the process of filing an adversary proceeding to discharge federal student loans.

Why individuals file Chapter 7 bankruptcy

The reasons why individuals file a Chapter 7 bankruptcy vary. This testimony will not discuss every reason, but rather the reasons PLC sees in its bankruptcy work. For the most part, the debtors PLC sees are forced to file for bankruptcy when they suffer a loss of income and are unable to pay their debts. This loss of income can be the result of the loss of a job, the loss of a spouse, an illness or injury, or a reduction in hours worked. Before the loss of income, these debtors were able to pay their debts. Often, we hear that they never expected to find themselves in a position where they had to choose between paying rent or paying a credit card bill.

At this point, it is important to discuss the emotions involved in a decision to declare bankruptcy. I have never met with a debtor who is "excited" to file for bankruptcy. For the most part, debtors are worried about the impact bankruptcy will have on their emotional, financial, and personal lives. A good bankruptcy attorney always advises debtors on the impact a bankruptcy will have on a debtor's rental prospects, ability to obtain affordable credit, and, in some cases, employment prospects. A good bankruptcy attorney explains how a bankruptcy opens up a debtor's financial history, requiring a debtor to list not only every debt owed, but every possession owned, every type of income received, and information such as property transferred and certain payments made going back years in some cases.

In addition, most of the debtors PLC sees are, frankly, ashamed that they are in a position to need to file for bankruptcy. People want to pay their debts. The debtors I see have a sense of personal responsibility and believe they are hurting their creditors by filing for bankruptcy. They simply do not feel good about filing for bankruptcy. It usually takes reviewing all income sources and all expenses and getting a debtor to see that it is impossible to make ends meet and pay their debts without bankruptcy.

In sum, filing bankruptcy is very rarely a decision made without much thought and it is almost always a decision of last resort. Debtors return to PLC's bankruptcy clinic multiple times and sometimes take months before they finally decide to file.

Determining feasibility of a student loan discharge

The idea that restoring a temporal discharge option would cause debtors to rush to the courthouse does not match the reality we see at PLC. In our experience, debtors will avoid bankruptcy if they have any other realistic option. Currently, before advising a debtor to consider the possibility of seeking an undue hardship discharge, PLC completes an extensive preliminary analysis to determine whether the borrower qualifies for any available programs offered by the Department of Education, including a total and permanent disability discharge or an income-driven repayment plan. If there is a path to help debtors handle their student loan debt outside of bankruptcy, debtors usually want to pursue it. Unfortunately, there are many people who cannot be helped by these non-bankruptcy programs.

Total and Permanent Disability Discharge

Borrowers are eligible for a total and permanent disability discharge (TPD) if they can provide documentation showing they meet the U.S. Department of Education's requirements for being considered totally and permanently disabled. Borrowers eligible for a TPD discharge through a VA disability determination, Social Security Disability Insurance, or Supplemental Security Income are usually informed of eligibility by the U.S. Department of Education.

Borrowers can also provide documentation from a physician certifying that the borrower is unable to engage in any substantial gainful activity due to a physical or mental impairment that can be expected to result in death; has lasted for a continuous period of at least 60 months; or can be expected to last for a continuous period of at least 60 months. Substantial gainful activity is a level of work performed for pay or profit that involves doing significant physical or mental activities, or a combination of both.

If a debtor appears to qualify for a TPD discharge, PLC will assist the borrower in obtaining the required documentation. If successful, PLC will not seek to discharge the federal student loans in bankruptcy. If unsuccessful, PLC will work to get the borrower into an appropriate IDR plan.

Income-driven repayment plans

Preliminarily, parent PLUS borrowers are not eligible for any of these income-driven repayment (IDR) plans. However, parent PLUS borrowers can consolidate their parent PLUS loans and then chose only the income-contingent repayment plan for the new Direct Consolidation loan.

Federal Family Education Loans (FFEL) borrowers are only eligible for the income-based repayment plan.

There are four income-driven repayment plans:

- Revised Pay As You Earn Repayment Plan (REPAYE Plan): The payment amount is determined based on adjusted gross income. Payments are capped at 10% of discretionary income. (This is defined as adjusted gross income above 150% of the relevant poverty level income divided by 12). A borrower must renew eligibility every year. Under this plan, there is no limit (or cap) on the monthly payment. This means that higher income borrowers could end up with payments even higher than the standard ten year plan. Borrowers can always switch to a different plan if they prefer.

- Pay As You Earn Repayment Plan (PAYE Plan): The payment amount is determined based on adjusted gross income. Payments are capped at 10% of discretionary income.[3] A borrower must renew eligibility each year. This plan is only available to Direct Loan borrowers that took out loans during certain time periods.

- Income-Based Repayment Plan (IBR Plan): The payment amount is determined based on adjusted gross income. Payments are capped at 10% of discretionary income for new borrowers on or after July 1, 2014 and 15% of discretionary income for those borrowing before July 1, 2014.

- Income-Contingent Repayment Plan (ICR Plan): The payment amount is determined as the lesser of 20% of discretionary income or what a borrower would pay on a repayment plan with a fixed payment over the course of 12 years, adjusted according to income.

All of these repayment plans offer loan forgiveness after 20 or 25 years of repayment. This forgiveness is currently considered taxable income, which may result in a significant tax burden on especially low-income borrowers.

If a borrower has not sought to apply for an IDR plan, PLC advises the debtor to apply and attempt to make the required payments. PLC will not seek to discharge federal student loans in bankruptcy if the debtor has not applied for an IDR plan.

If a borrower is on an IDR plan, PLC works with the debtor to ensure they are on the appropriate plan. If the debtor is on the appropriate plan and cannot afford the IDR payment amount, PLC conducts and additional review of the debtor's financial situation. This process is time-consuming and involves several conversations about increasing income and reducing expenses.

---

[3] For Income-Based Repayment, Pay As You Earn, and loan rehabilitation, discretionary income is the difference between a borrower's annual income and 150 percent of the poverty guideline for the borrower's family size and state of residence. For Income-Contingent Repayment, discretionary income is the difference between a borrower's annual income and 100 percent of the poverty guideline for the borrower's family size and state of residence. (https://studentaid.gov/help-center/answers/topic/glossary/article/discretionary-income)

For the most part, by the time a debtor gets to the point of considering bankruptcy and trying to discharge their student loan, they have exhausted options for increasing income and decreasing expenses. In fact, borrowers we work with are often unable to afford rent in Orange County and end up relying on friends, and in some cases family, for free or reduced-cost housing. These debtors are often working as much as they can, and usually have some limitations as to the type of work and how much work they can perform. The limitations, however, do not rise to the level of a disability making it unable for them to engage in any substantial, gainful activity.

<u>Not all borrowers qualify for IDR plans</u>

Other borrowers are unable to qualify for IDR plans, including parent PLUS borrowers and borrowers who have been sued by the United States to recover payments on student loans whose cases have resulted in a judgment against them. For borrowers with judgments, they cannot consolidate or rehabilitate their loans, meaning that the only way for the borrower to get out of default is by paying their loans in full, or by discharging their loans in bankruptcy.[4]

For borrowers who do not qualify for IDR plans, PLC engages in the conversation about increasing income and reducing expenses discussed above.

The process of filing an adversary proceeding to discharge federal student loans

Discharging federal student loans in bankruptcy through undue hardship is not a simple process. In addition to preparing and filing a chapter 7 bankruptcy petition, a debtor must initiate a separate litigation against the U.S. Department of Education within the bankruptcy called an adversary proceeding ("AP"). This requires a complaint alleging facts sufficient to support the claim that the repayment of the loans would result in an undue hardship on the debtor. Once service of the summons and complaint is accomplished, the Department of Education responds to the complaint. Once the pleadings are at-issue, the litigation proceeds. A status conference is scheduled, discovery is conducted, mediation is attempted, motions are filed and argued, and, if a settlement cannot be reached, a trial is held.

When PLC decides to represent a debtor in their bankruptcy and to bring an AP to discharge student loans, we have already spent dozens of hours questioning the debtor's income and expenses, and having the debtor try ways to increase income and/or decrease expenses. We have prepared the Chapter 7 bankruptcy petition and listed all of the debtor's assets, debts, current income, current expenses, and income for the previous two years.

[4] For more on debt collection lawsuits brought against borrowers, please see Margaret Mattes and Persis Yu, *Inequitable Judgments: Examining Race and Federal Student Loan Collection Lawsuits*, Nat'l Consumer Law Ctr., (2019), https://www.nclc.org/images/pdf/student_loans/report-inequitable-judgments-april2019.pdf

The complaints we prepare are detailed, and explain why someone unable to pay rent but whose friends and family provide a couch or a bed, is not maintaining a minimal standard of living and why they should not be expected to rely on their friends and families for a place to live. The complaint lays bare tragic realities of someone in so much pain continuing to work for minimum wage because they cannot afford not to. Facts that bring pain to a debtor are made public in order to provide a chance at being released from the burden of paying federal student loans, for example that parents are forced to deny their children the simple joys of toys and excursions because their IDR requires a monthly payment of $75.00.

Even with these tragic facts, there is a fight about undue hardship. Every one of the complaints PLC filed to discharge students loans was contested, leading to an often lengthy process.

In this process, the court is required to determine whether payment of the loans will result in an undue hardship on the debtor and the debtor's dependents. The "undue hardship" standard is not defined in the Code and bankruptcy judges have significant discretion to make their decisions. Although most circuits use the *Brunner*[5] test to analyze a debtor's situation and make a determination of undue hardship, decisions are arbitrary and often unfair to debtors.

The *Brunner* test requires a showing that 1) the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for the debtor and the debtor's dependents if forced to repay the student loans; 2) 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) the debtor has made good faith efforts to repay the loans.

Over the years, these three prongs of *Brunner* have been interpreted by courts in various ways. The prongs require an extraordinarily fact-intensive analysis that can often seem like putting the square pegs of a borrower's financial life into the round hole of *Brunner*. Even the question of what constitutes a minimal standard of living prompted a court to provide a list of elements that are "included" in a minimal standard of living but that, by the opinion's language, is a non-exhaustive list.[6]

While PLC sees challenges in meeting each of the prongs of *Brunner*, the prong I would like to focus on is the second one: 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. While many of the debtors we see are able to establish the first prong, the second prong is almost impossible to establish.

On average, the debtors we speak with who are considering discharging their student loans are in their mid-to-late 30s into their 40s. We also have a number of borrowers over the age of 60 who are considering discharging either their own student

---

[5] *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F. 2d 395 (2d Cir. 1987).
[6] *Ivory v. United States (In re Ivory)*, 269 B.R. 890, 899 (Bankr. N.D. Ala. 2001).

loans or, more often, a parent PLUS loan they took out for a child. We also see borrowers who are able to work despite a disability, but not enough to afford their IDR plan payments. These borrowers either cannot qualify for SSDI or cannot survive on SSDI benefits alone and need to bring in more income than SSDI benefits provide.

For those borrowers in their 30s and 40s, they have been out of school for several years but have been unable to increase their earning potential. Many attended schools that misrepresented their earning potential and did not provide a quality education. While they all hope and wish to earn more money in their lives, the reality is that lower-income individuals, and especially borrowers of color, are too often trapped in a cycle of poverty. Nonetheless, the general belief is that individuals do not reach their maximum earning potential until they are in their late 40s or 50s. As a result, the argument against discharge is almost always "but they will eventually earn more." As it is impossible to disprove a theoretical future, this is where borrowers lose their cases.

While theoretically a 35-year-old making minimum wage now could eventually make more, this "theoretical" future usually never comes to pass. This theoretical future can be disrupted by unexpected illnesses, job losses, or the need to leave the workforce to care for family. If the last year has taught us anything, it's that the future of our earning potential can be completely out of our control.

For those borrowers over 60, while the argument of future earning potential is not as strong, the first prong of *Brunner* creates a situation where, in order to establish the second prong, the elder borrower may be expected to take on part-time work in retirement, or may be expected to delay retirement rather than having their loans discharged.

While each of the above situations is heartbreaking, the borrowers we struggle most with are those who have health impairments but either who cannot survive on SSDI payments or can engage in substantial gainful employment and thus cannot qualify for SSDI. So, they work as much as they can, but they cannot work enough to actually be able to afford student loan payments. While they may "technically" maintain a minimal standard of living, practically, they live paycheck to paycheck and choose between paying even a $25 a month student loan payment and paying a utility bill. Some of these borrowers are in professions that theoretically have a higher earning potential, raising the challenge of the second prong. However, these borrowers' disabilities prevent them from working full-time, or sufficient hours to support themselves and their families in any meaningful way.

I will reiterate that Orange County, where Public Law Center is located, has a cost of living the cost of living that is 87% higher than the national average, and its housing costs alone are 374% higher than the national average.[7] That is not a typo – three hundred seventy four percent. And housing costs are rising.

[7] Orange County Community Indicators 2020-2021, p. 109, https://www.ocbc.org/wp-content/uploads/2020/09/2020-Community-Indicators-Report.pdf

Again, technically, all of these borrowers can maintain a "minimal" standard of living and are on IDR plans if they qualify. Practically, however, without the ability to discharge their federal student loans, their futures are bleak, they cannot save money for an emergency, they cannot save for retirement, they cannot purchase a home, and in some cases they cannot support a family.

The current system is not working. The fact-specific demands of an undue hardship analysis place a tremendous burden on debtors, the courts, and even government counsel. The reality is that the undue hardship standard creates arbitrary, conflicting, and unfair results that negatively impact debtors. Reintroducing the temporal discharge option would remove the arbitrariness and unfairness from the undue hardship analysis by, in a sense, codifying the second prong of the *Brunner* test – if a borrower finds themselves in a situation where they have to file for bankruptcy ten years after their student loans become due, they have established the situation persisted for a significant portion of the repayment period of the student loans. No more theoretical futures and no crystal balls.

A note on bankruptcy abuse

The Chapter 7 bankruptcy process has a way of determining whether a debtor is abusing the bankruptcy process. Judges and trustees also have discretion to question debtors to determine whether a bankruptcy filing abused the bankruptcy process. The argument that student loan borrowers will rush to file for bankruptcy assumes that these borrowers will not have other debts to discharge. In some cases, the argument of bankruptcy abuse contains theories that rich doctors will file for bankruptcy just to get their student loans discharged.

Individuals who bring up the abuse of the bankruptcy process as a reason not to reinstate the temporal discharge option do not appear to have a strong understanding of bankruptcy, much less Chapter 7 bankruptcy.

Preliminarily, debtors with assets, including homes with significant equity, risk losing those assets in a Chapter 7 bankruptcy. A debtor can only protect a certain amount of assets. Assets above the protected amount, including a debtor's home, can be sold by the bankruptcy trustee to pay debt. This is probably one of the strongest deterrents to filing Chapter 7 bankruptcy.

Debtors with significant income may also be disqualified from filing a Chapter 7 bankruptcy. The means test limits how much income one can have in order to file a Chapter 7 bankruptcy. Debtors whose income is above their state's median income as determined by the U.S. Census Bureau cannot file a Chapter 7 bankruptcy unless they can show their disposable income, as determined using Internal Revenue Service data and standards devised by the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey (CES) and the U.S. Census Bureau, is below a certain amount. For reference the California median annual gross income for a household of one is currently $62,938.00.

Finally, the bankruptcy trustee and the bankruptcy judge have inherent power to challenge a Chapter 7 filing. Indeed, the 2005 amendments to the bankruptcy code were intended to curb and prevent abuse.

Conclusion

The current system is not working. It is actually failing borrowers who need their federal student loans discharged the most. It keeps individuals from the fresh start intended by our bankruptcy system. No one wants to file for bankruptcy, and borrowers who can manage their student debt through IDR programs without needing to resort to bankruptcy will do so. Those borrowers will not be rushing to file for bankruptcy if the temporal discharge option is reinstated. Their credit is too important. The borrowers who will take advantage of discharging their federal student loans in bankruptcy are those who have no other option for managing their student loan burden, or who have other, often significant debt, whose financial future is made bleaker by the debt they are unable to pay. It is these debtors who deserve a fresh start – a complete one.