

MarketWatch

These lawyers may have discovered a way to wipe away student debt in bankruptcy

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Federal student loans are exempt from discharge in bankruptcy — or are they?

*Getty Images*

Student loans are often dubbed the worst kind of debt because they're notoriously difficult to get rid of — even in bankruptcy. But attorneys across the country are now challenging that conventional wisdom with some success, creating hope for millions of struggling borrowers.

Bankruptcy lawyers are filing cases in states from New Hampshire to Florida, to test strategies with the hopes of establishing paths bankrupt borrowers and their lawyers can use to get rid of or, at least, better manage their debts in the future.

This burgeoning niche practice area — which includes paid seminars and new software programs — comes amid a rise in the share of bankruptcy filers with student debt and growth in their average balances. In 2005, roughly 15.7% of bankruptcy filings included educational debt with an average balance of \$15,350, [according to a 2014 paper](#) in the *Suffolk Law Review*. That's compared with 22.3% of filers with an average balance of \$32,096 in 2013.

"Nobody is doing anything for these people in terms of laws to benefit them," said Richard Gaudreau, a New Hampshire-based bankruptcy attorney, who's been working on student loan issues for the past few years. "We're just forced to be creative."

After a wave of panic in the 1970s over anecdotal evidence that student loan borrowers were taking advantage of the system to get rid of their debts, Congress exempted federal student loans from discharge in bankruptcy, except in extreme circumstances. Lawmakers extended that exemption in 2005 to private student loans as well. In order for borrowers to have their student debt discharged in bankruptcy, they need to prove that the debt is causing them to suffer "undue

hardship.” Congress never defined that phrase, but a series of court rulings has created an undue hardship standard that is notoriously difficult to meet.

So instead of trying to meet that standard, these attorneys are turning to other legal strategies that challenge private lenders’ ability to collect on the loan and in the case of federal debt — which is much harder to challenge — help borrowers better manage the loans while in bankruptcy.

Can employers solve the student-loan crisis?

(3:13)

A burgeoning industry of tech companies is enabling employers to make contributions toward their employees’ student loans. Could this be the answer to the \$1.3-trillion student-debt crisis?

A law student’s experiment

When Austin Smith, a New York City-based lawyer, was researching a law review article at the University of Maine in 2014, he realized bankruptcy attorneys rarely objected to lenders’ classification of their clients’ debts as non-dischargeable in bankruptcy, likely because they weren’t familiar with the ins and outs of bankruptcy law as it pertains to student loans. But Smith discovered that in many cases, the debts didn’t meet the standard of a qualified student loan under the bankruptcy code. That could be because the lender extended the loan to the borrower to attend an unaccredited program or lent the borrower more than the cost of attendance.

As a young corporate lawyer, [Smith tested the strategy](#) working pro-bono for a client who racked up \$15,000 in debt from a bar study program. He successfully got the loan discharged and shortly thereafter struck out on his own doing solely this kind of work. He has about 20 cases pending and there are some early signs he may be onto something.

In December, a Minnesota bankruptcy judge responded to a motion Smith filed on behalf of a client in a case against Navient, one of the nation’s largest student loan companies, disputing the way Navient, other lenders and bankruptcy judges have historically interpreted a provision of the bankruptcy code as it relates to student debt.

In order for a student loan to be non-dischargeable in bankruptcy, it has to fit into one of a few categories. Some examples include:

- A federal student loan
- Debts made under a program funded in whole or in part by a nonprofit institution (typically these are loans made by the school)
- A qualified educational loan — this can be a loan made by a private company, but it has to be made for qualified higher education expenses, typically defined as the cost of attendance, for a student attending an eligible institution.
- Funds received as an “educational benefit”

Lawyers and judges have long taken the phrase “educational benefit” to include loans. But Smith’s interpretation, which the judge concurred with, is that the category refers to scholarships and grants that must be paid back if certain stipulations are violated. For example, if a student accepts a scholarship for medical school with the premise that they’ll work in a low-income community and then they violate that condition and are on the hook for the money.

Taking that logic one step further means that student loans from private lenders can be discharged in bankruptcy if they were made to students who didn’t attend an accredited program or were lent more money than the cost of attendance. Possible debts that fit into this category could include the aforementioned bar study loan or a loan to attend an unaccredited trade school, Smith said.

“A loan is not like a scholarship or a stipend and such a private loan cannot be included in this definition. If I were to interpret educational benefit to include loans that has some relation to attaining an education, it would render the other two provisions of [the bankruptcy code as it relates to student debt] totally superfluous,” the judge said, according to a transcript.

"I have yet to go in front of a judge who disagrees with my overall thesis, which is that not all student loans are not dischargeable," Smith said. "I do think the tide is now turning on that."

Patricia Christel, a Navient spokeswoman, declined to comment on the specific case. She wrote in an emailed statement that the company "continues to support" reforms that would allow both federal and private student loans to be discharged in bankruptcy for borrowers who made a "good-faith" effort to repay the debt for five to seven years and still experienced financial difficulty.

Burden of proof

And soon more attorneys may give Smith's strategy a try. Dayton, Ohio-based CINGroup, which makes a software used by bankruptcy attorneys to prepare their filings, called Best Case, plans to introduce an update later this year that will help scan a client's student loans to see if they qualify for any discharges and help prepare the filings to challenge the debt.

Dave Danielson, the chief executive of CINGroup says the company estimates that of the 750,000 consumer bankruptcies filed each year, there could be as many as 50,000 with some kind of dischargeable student debt, but it rarely gets challenged. "Most attorneys, they process bankruptcies every day and their heads are down and it's easy to fall under the assumption that student loan debt — you can't do anything about it," he said. "What we're trying to do in a very simple sense is help the attorney realize that (a) maybe they can do something about it and (b) if it's dischargeable, try to prepare some legal proceedings."

Gaudreau first realized he had the power to help bankruptcy filers with student debt a few years ago, after he almost took a client's case all the way to the Supreme Court. Now he uses a variety of strategies to help his clients get rid of or better cope with their loans. In many cases, he challenges private lenders to provide evidence they can legally collect on the debt. Often, in scenarios reminiscent of the mortgage crisis, since the loan has changed hands many times, the lenders struggle to provide that evidence.

"They're not very good at supplying the documents that prove that they own the debt," he said. If the lender can't prove they own the debt, then it makes it much more difficult for them to collect on it.

Lawyers may still be in the early stages of pioneering these strategies, but they've been available all along, said Rafael Pardo, a professor at Emory University's law school who has studied bankruptcy and student loans. The burden of proof both that the borrower owes the debt and that it's a type of debt that qualifies for exemption falls on the creditor. But borrowers and attorneys may be hesitant to pursue this path if they don't have the money or experience to pay for it.

"The overwhelming majority of the litigation has always turned on was there undue hardship or not," he said. "The type of debt or the amount of debt was a forgone conclusion. When you're stuck with limited resources in terms of the representation, you have to pick and choose your battles."

In the case of federal student loan debt, trying to get it discharged is likely a losing battle if the attorney can't make a particularly compelling case that the debt qualifies as an undue hardship for the borrower, said Lewis Roberts, a Florida bankruptcy attorney. In most jurisdictions, a borrower is only considered to be suffering from undue hardship if she's in a situation where she currently can't pay the debt, there's no reason to believe she'll be able to pay the debt in the future and she's made a good-faith effort to repay the loan. Judges have said prolonged unemployment, alcoholism, and even a criminal record aren't enough to qualify a borrower for the undue hardship designation.

'The fight is just in its infancy'

In cases where borrowers don't meet the undue hardship standard, Roberts is working to at least help his clients better manage the debt once in bankruptcy.

Typically, federal student loan debt is categorized in bankruptcy the same as other unsecured debts owed by the filer. Roberts's intervention is to get judges and trustees to classify the federal student loan debt separately so that his clients can take advantage of special payment plans the government offers borrowers to manage their student loans. Using this

method, he's helped clients who are in bankruptcy put their student loans into income-driven repayment plans that allow borrowers to pay as little as zero dollars a month and stay current on their loans. Borrowers who are on these plans are also able to make payments toward loan forgiveness programs.

Lewis said he first started doing this work about three years ago after attending a seminar about legal issues relating to student loans, including bankruptcy, hosted by two lawyers who had already begun working in the space. The attorneys offer [these so-called student loan workshops](#) either as videos, phone calls, in-person trainings or a combination. The workshops, which cost between \$1,500 and roughly \$2,500, depending on what services you purchase are pitched both as a way to help student loan borrowers, but also as a way for attorneys looking to drum up business in a struggling bankruptcy market. So far about 300 lawyers have participated in the student loan workshops since they launched in 2012.

As more lawyers learn both about the problem of student debt in bankruptcy and the opportunity to solve it, the challenges to the conventional wisdom that student loans are impossible to get rid of will only increase, said Jay Fleischman, one of the attorneys who runs the student loan workshops. "This fight is just in its infancy," he said. "We're seeing the birth of it in many ways."

Read more about student loans and bankruptcy:

- [Why student loan borrowers should pay attention to these two court cases](#)
- [Can money you borrow to pay for private high school be discharged in bankruptcy?](#)
- [This dad is a step closer to wiping out \\$200,000 in student loans](#)

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