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CHANGING UP THE CODE

G. Eric Brunstad Jr., Dechert LLP, Hartford, CT
Mette H. Kurth, Culhane Meadows, PLLC, Wilmington, DE
John C. Rao, National Consumer Law Center, Inc., Boston, MA

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<u>Substantial Abuse Dismissal Proposal – Elimination of Means Test</u>
G. Eric Brunstad, Jr.

11 U.S.C. § 707

(a) After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, trustee (or bankruptcy administrator, if any), or any party in interest, may dismiss a case under this chapter for cause, including—

(1) unreasonable delay by the debtor that is substantially prejudicial to creditors;

(2) nonpayment of any fees or charges required under chapter 123 of title 28, but only upon a motion by the United States trustee;

(3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521(a), but only on a motion by the United States trustee; or

(4) if the continuation of the case would constitute a substantial abuse of the provisions of this chapter.

(b) (1) In making a determination whether to dismiss a case under this section, the court may not take into consideration whether an individual debtor has made, or continues to make, charitable contributions (that meet the definition of "charitable contribution" under section 548(d)(3)) to any qualified religious or charitable entity or organization (as that term is defined in section 548(d)(4)).

(2) In considering whether to dismiss a case under this section on the ground that the continuation of the case would constitute a substantial abuse of the provisions of this chapter, the court shall consider—

(A) whether the debtor filed the petition in bad faith; or

(B) whether the totality of the circumstances demonstrates abuse, including the solvency or insolvency of the debtor, and whether the debtor seeks to reject a personal services contract and the need for such rejection.

(3) The court, on its own initiative or on the motion of a party in interest, in accordance with the procedures described in rule 9011 of the Federal Rules of Bankruptcy Procedure, may order the attorney for the debtor to reimburse the trustee for all reasonable costs in prosecuting a motion filed under section 707, including reasonable attorneys' fees, if—

(A) a trustee files a motion for dismissal or conversion under this subsection; and

(B) the court—

(i) grants such motion; and

(ii) finds that the action of the attorney for the debtor in filing a case under this chapter violated rule 9011 of the Federal Rules of Bankruptcy Procedure.

(C) The signature of an attorney on a petition, pleading, or written motion shall constitute a certification that the attorney has—

(i) performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion; and

(ii) determined that the petition, pleading, or written motion—

(I) is well grounded in fact; and

(II) is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1).

(D) The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is materially false.

(4) The court, on its own initiative or on the motion of a party in interest, in accordance with the procedures described in rule 9011 of the Federal Rules of Bankruptcy Procedure, may award a debtor all reasonable costs (including reasonable attorneys' fees) in contesting a motion filed by a party in interest (other than a trustee or United States trustee (or bankruptcy administrator, if any)) under this subsection if—

(A) the court does not grant the motion; and

(B) the court finds that—

(i) the position of the party that filed the motion violated rule 9011 of the Federal Rules of Bankruptcy Procedure; or

(ii) the attorney (if any) who filed the motion did not comply with the requirements of clauses (i) and (ii) of paragraph (4)(C), and the motion was made solely for the purpose of coercing a debtor into waiving a right guaranteed to the debtor under this title.

(c) (1) In this subsection—

(A) the term "crime of violence" has the meaning given such term in section 16 of title 18; and

(B) the term "drug trafficking crime" has the meaning given such term in section 924(c)(2) of title 18.

(2) Except as provided in paragraph (3), after notice and a hearing, the court, on a motion by the victim of a crime of violence or a drug trafficking crime, may when it is in the best interest of the victim dismiss a voluntary case filed under this chapter by a debtor who is an individual if such individual was convicted of such crime.

(3) The court may not dismiss a case under paragraph (2) if the debtor establishes by a preponderance of the evidence that the filing of a case under this chapter is necessary to satisfy a claim for a domestic support obligation.

<u>Summary Outline of the Presentation in Support of the Proposal</u>

—Origins of the Means Test

—A brief history of underwriting
—Portfolio management
—Squeezing distressed debtors

—A Solution to a Problem That Never Existed

—Reasons debtors file for bankruptcy:

(1) loss of employment;
(2) catastrophic medical; and/or
(3) divorce

—actual incidence of abuse negligible

—The Enormous Deadweight Administrative Costs of the Test

—Increased administrative burden
—Costs of delay
—Costs of test avoidance
—Costs of failed Chapter 13 alternative

—The Test's Unfortunate Externalities

—Those who benefit from the test do not bear the cost

—The Nonexistent Policy Justifications for Retaining the Test

—Debtor abuse
—Chapter 13 as an alternative given applicable constitutional norms

—The Policy Justifications for Abandoning the Test

—Targeting the real problems
—Avoiding the costs of the current test
—Constitutional norms

—The Justifications for the Proposal

—Bankruptcy courts as courts of equity
—Balancing the right factors

<u>Redline to Existing Statutory Text</u>

11 U.S.C. § 707

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(D) whether the totality of the circumstances demonstrates abuse, including the solvency or insolvency of the debtor, and whether the debtor seeks to reject a personal services contract and the need for such rejection.

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(I) is well grounded in fact; and

(II) is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1).

(D) The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is materially false.

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(3) The court may not dismiss a case under paragraph (2) if the debtor establishes by a preponderance of the evidence that the filing of a case under this chapter is necessary to satisfy a claim for a domestic support obligation.

THE PRE-PETITION KERP PITCH

Bankruptcy Code section 548 should be amended in three key respects:

1) Section (a)(1)(B)(ii)(IV) eliminates the need to prove insolvency for insider compensation awards outside the ordinary course of business; this should be expanded to include *all* insider compensation within the 90 days pre-petition;

2) A new provision should be added creating a presumption that insider compensation granted during the 90 days prepetition is presumed not to have been in exchange for reasonably equivalent value if: (1) the compensation is greater than normal, pre-bankruptcy compensation levels for that insider or that position; or (2) if the insider compensation, if sought post-petition, would not have satisfied the requirements of Section 503(c) re: Key Employee Retention Plans ("KERP") and Key Employee Incentive Plans ("KEIPs"); and

3) A new provision should be added—similar to state law provisions regarding illegal dividends—making non-dissenting directors jointly and severally liable to the trustee for any such avoidable fraudulent transfers.

THE PROBLEM

1) The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") imposed significant changes to U.S. bankruptcy law. Section 503(c) of the revised law imposed several restrictions on the use of retention plans for insiders in the context of a bankruptcy proceeding. If a company's key employee compensation plan does not provide for incentive-based compensation and is solely based on retention, it is a "KERP" subject to restrictions under Section 503(c)(1) which strictly restricts payments to insiders. The challenges and restrictions on using KERPs initially caused many companies entering bankruptcy to pivot away from KERPs for insiders and towards performance-based incentive plans, or "KEIPs," which properly implemented are not subject to the limitations of Section 503(c)(1).

2) My proposal addresses the recent explosion—and increasingly "ordinary"—use of "*pre-petition* KERPs"—which circumvent Section 503(c)(1) in its entirety and have come under scrutiny as an end-run around BAPCPA's amendments to the Bankruptcy Code—by amending Section 548 to create meaningful claw back provisions to enable creditors to recover excessive eve-of filing bonuses while incentivizing officers and directors of financially distressed companies to utilize post-petition KEIPs, subject to judicial and creditor oversight, rather than using pre-petition KERPs to avoid Section 503's restrictions on executive compensation.

REASONS WHY MY PROPOSAL IS NEEDED

1) There has been a rash of firms adopting prepetition KERPs.

    a) OTC Holdings set up a prepetition KERP designed to pay bonuses only after the company emerged from bankruptcy, thus arguing that Section 503 did not apply.[1]

    b) Regent Communications implemented a KERP that was triggered upon commencement of the chapter 11 cases.[2]

    c) JC Penney awarded nearly $10 million in bonuses to four senior-most executives five days before filing.[3]

    d) Hertz Corp. adopted a $16 million KERP one week before filing.[4]

    e) Whiting Petroleum Corp. $14.6 million, including $6.4 million for its CEO.[5]

    f) Libbey Glass filed chapter 11 after paying out about $3.1 million in bonuses to its executives, including just over $2 million to its CEO and four other executives.[6]

    g) Extraction Oil & Gas, Inc. paid $6.7 million under retention agreements with 16 executives and senior managers immediately prior to a default and bankruptcy filing.[7]

    The phenomenon of paying eve-of-filing bonuses is not entirely new but it appears it is being employed with increasing frequency. This suggests that Chapter 11 practitioners have become increasingly comfortable and confident in recommending that prospective debtors make such payments pre-filing. Absent a successful challenge to this practice, **this trend may continue to the point that eve-of-bankruptcy retention bonuses become the rule rather than the exception.**

2) BAPCPA ostensibly gives creditors a potential means of challenging eve-of-bankruptcy retention bonus payments. Under Section 548(a)(1)(B), the trustee can avoid and recover a constructive fraudulent transfer made by a debtor within two years pre-filing if the debtor was insolvent and did not receive reasonably equivalent value. **BAPCPA relieves the trustee from the burden of proving insolvency for transfers made by a debtor to an insider under an**

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1 *See* Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. Cal. L. Rev. 654 (2019).

2 *Id.*

3 *See* David Farrell, *Payday Before Mayday: The Increasing Use of Pre-Bankruptcy Executive Retention Bonuses*, July 17, 2020, at https://www.jdsupra.com/legalnews/payday-before-mayday-the-increasing-use-43713.

4 *See Id.*

5 *See* Mike Spector and Jessica DiNapoli, *On Eve of Bankruptcy, U.S. Firms Shower Execs With Bonuses*, June 13, 2021, at Reuters.com.

6 *See* D.Farrell, *Payday Before Mayday*.

7 *Id.*

employment agreement and not in the ordinary course of business. Instead, the trustee need only prove that the debtor received less than reasonably equivalent value for the payment. BUT, in the context of eve-of- filing retention bonuses, proving insolvency is usually not difficult; **from an evidentiary standpoint, the far more challenging and contentious element of proof is that that the debtor did not receive reasonably equivalent value.** This is evidenced by the fact that, despite a marked uptick of Committee and UST litigation and activism, and associated costs, parties in interest rarely succeed in making material changes to KEIP programs, presenting more than pro-forma/recycled objections, or successfully challenge pre-petition payments.

- Hostess Brands filed a so-called "Chapter 22." Hostess Brands raised the salary of its CEO from $750,000 to $2,550,000 (approximately 300%) and gave large raises to nine other key executives six months prior to filing its bankruptcy petition. The Committee investigated, and in response, the post-filing CEO intervened and drastically slashed most of the prior compensation packages after which the Committee elected not to pursue the matter further.

- Toys-R-Us filed suit against various D&O for implementing a $7 million retention bonus program in the week prepetition. The complaint alleges that outside bankruptcy counsel specifically advised the former CEO of the bankruptcy law restrictions on the award of such bonuses and that, in a deliberate effort to circumvent BAPCPA, the CEO ordered the bonuses to be paid three days prepetition. Bankruptcy administrators are now trying to put its former top leaders on trial before a jury over the millions of dollars in bonuses they pocketed days before the company's plunge into bankruptcy.

3) While relatively fewer firms use court-approved bonus plans post-BAPCPA, the overall level of executive compensation appears to be similar. A recent study published in the USC Law Review demonstrates that this is likely because BAPCPA left large gaps that make it easy for firms to bypass the law and pay executives without court oversight.[8] For example, BAPCPA only regulates payments characterized as bonuses during the period when firms are in Chapter 11. **Firms can easily sidestep BAPCPA by paying managers before or after the bankruptcy case, and many appear to have done so.**

4) Populist outrage over high levels of executive pay and "bankruptcy bonuses," and **a sense that management is exploiting the basic structure of Chapter 11 to extract undeserved pay, undermines public confidence in the bankruptcy process**. The bonus debate comes amid a broader public outcry over executive pay that intensified during the financial crisis and recession. (Today, CEOs earn more than 300x the average worker's pay, up from 70x three decades ago).[9]

5) Research done by Ethan Bernstein, a Kauffman Foundation Fellow on leave from Harvard Law School, shows that CEOs of financially troubled companies quit or are ousted at the same rate whether they file for bankruptcy or muddle through with private restructuring. For some, this raises the troubling possibility that **retention bonuses are not a necessary tool to ensure**

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8 Jared A. Ellias, *Regulating Bankruptcy Bonuses*, 92 S. Cal. L. Rev. 654 (2019).

9 *See* Mike Spector and Tom McGinty, *The CEO Bankruptcy Bonus: Firms Sidestep Rule Limiting Rewards for Executives*, January 27, 2012, at www.wsj.com.

continuity of management, but that **Chapter 11 has become a back door for CEOs to grant themselves raises**, especially since the Journal's research found CEOs at some troubled firms earned more after filing for Chapter 11.[10]

6) Sections 170(a) and 174(a) of the Delaware General Corporation Law ("DGCL") make a director liable to the corporation, or its creditors in the event of insolvency, for the full amount of any illegal dividend, including those paid while "the corporation's capital . . . is less than the capital represented by all outstanding shares having a preference upon the distribution of assets." In *Horbal v. Three Rivers Holdings, Inc.*, minority shareholders in a health maintenance organization ("HMO") sued corporate directors for "siphoning off tens of millions of dollars from the HMO in the form of disguised salaries, bonuses and corporate perquisites," which the plaintiffs asserted were really "de facto dividends."[11] Judge Chandler rejected plaintiffs' theory on the ground that "[n]o Delaware court ha[d] ever recast executive compensation as a constructive dividend[.]"[12]Instead, Judge Chandler found that the plaintiffs' claim implicated "a classic allegation of self-dealing or waste" subject to attack as a violation of the fiduciary duty of loyalty.[13] **Outside of Delaware**, however, **several courts have been willing to recast inordinate executive compensation as *de facto*, disguised, or constructive dividends, particularly in the case of closely held corporations**. These claims may be brought by creditors or minority shareholders and can be framed as tort or statutory claims. For example, in the recent case of *Tisch v. Tisch*,[14] the Colorado Court of Appeals found that a controlling shareholder's use of company funds from a family-owned liquor store for the payment of excessive salary, personal credit cards, and unauthorized loans qualified as disguised dividends supporting minority shareholders' civil theft claim.[15]

REASONS TO REJECT MY PROPOSAL

1) In the past, much of the blame for failed businesses fell on the shoulders of the executives leading them. Poor decision making, over-leveraging the balance sheet, and imprudent use of capital resulted in poor financial performance and an ultimate decline of the business. High bonuses that were perceived as rewarding failure came under heavy scrutiny. **However, most recent bankruptcies have been a direct result of macro-economic issues that were largely outside of executive control.** This has resulted, in most cases, in the desire to retain executives through the restructuring, with the intention of having them continue running the business upon emergence. This strategic shift necessitates a re-thinking in the approach to bankruptcy compensation.

2) The issue with KEIPs in a retention-focused scenario is the often significantly reduced total compensation opportunity coupled with a higher risk of forfeiture. This makes these programs

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10 *See* Martha C. White, *CEO's Rake in Huge Sums When Their Companies Go Bankrupt*, Jan. 27, 2012 at www.nbcnews.com.

11 *See Horbal v. Three Rivers Holdings, Inc.*, Civ.A. 1273-N, 2006 WL 668542, at *1 (Del. Ch. Mar. 10, 2006).

12 *Id.* at *3.

13 *Id.* at *4.

14 *Tisch v. Tisch*, 439 P.3d 89 (Colo. App. 2019).

15 *See* J. William Boone and Matthew M. Graham, *A Third Way: Recovery of Excessive Executive Compensation as Disguised Unlawful Compensation*, June 13, 2021, at www.businesslawtoday.org.

disincentivizing as stand-alone programs. **Pre-petition KERPs are necessary to keep executives and avoid the limitations of KEIPs and the difficulties and expense of creditor negotiations and judicial oversight.**

3) Pre-petition KERPs are increasingly being used as stand-alone programs, with many companies merely trying to deliver normal aggregated total compensation through these programs with little or no diminishment from the normal value. In a review of 32% pre-petition KERPs, where no associated KEIP was present, the average CEO maintained 83% of their normal pre-bankruptcy total compensation value.[16] This includes long-term equity awards. Other executives kept an average of 78%.[17] In eight of these cases, CEOs maintained 100% of their total compensation value delivered in a typical annual cycle in the way of a guaranteed retention bonus, while the remaining 24 experienced varying degrees of lesser value.[18] There were a few instances where significant reductions occurred. Unfortunately, there are examples where advisors have developed programs, which are approved by the board, which are blatantly unreasonable. **But the concerns with systemic failure are overblown.**

4) **Executive turnover in bankruptcy situations where pre-petition KERPs have been used is less than 1%, speaking volumes about the effectiveness of the retention characteristics of these programs.**[19] There is no better vehicle if retention is the goal.

5) Pre-BAPCPA, the median debtor's counsel billed $30,000 for work on bankruptcy bonus plans; post-BAPCPA, the median was $86,000, a 64% increase.[20] Moreover, official committees have become more litigious, filing 80% more objections to executive compensation programs.[21] And the US Trustee has become far more litigious, objecting to almost half of all filed bonus plans, a 300% increase.[22] While the percentage of firms filing for bankruptcy that seek a bonus plan fell from 60% pre-BAPCPA to less than 40% post-BAPCPA, there is no statistical difference in the overall level of executive compensation before or after the reform; CEOs received nearly identical bonuses pre- and post-BAPCPA.[23] In addition to sidestepping BAPCPA, **evidence suggests that debtors' counsel has become adept at changing the form of KERPs into compliant KEIPs without changing the substance or level of executive compensation**; bonus plans post-BAPCPA are much more likely to include some sort of operational or financial target that rewards management for meeting specific performance objectives. **Amending Section 548 to force more companies to submit to a post-bankruptcy process will merely impose more costs on debtors' estates without creating meaningful changes.**

6) **Successfully guiding a company through bankruptcy and emerging on the other side is a challenging, risky job**, and it is in the best interest of creditors to ensure management continuity by properly incentivizing management to stay with a troubled company.

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16 Kevin Kuschel, Daniel Wilson, and Brent Longnecker, *Pre-Petition Retention Awards: Important Tools or Excuses for Excessive Compensation?*, July 27, 2020, at www.longnecker.com/blog.

17 *Id.*

18 *Id.*

19 *Id.*

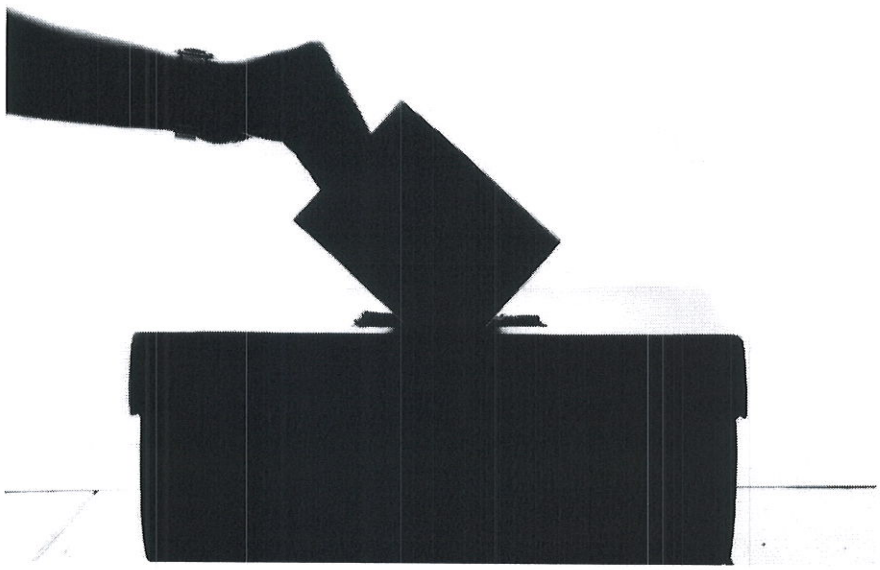
20 *See* J.Ellias, *Regulating Bankruptcy Bonuses*, at 673.

21 *Id.* at 691.

22 *Id.* at 693.

23 *Id.* at 674.

7) Congress should revisit the entire regulatory framework from 2005 and start over. A better approach would be to move away from distinguishing “incentive” and “retention” bonuses and force Chapter 11 firms to justify all executive compensation with data on historic practice and prevailing market conditions. Unless companies can show some special justification, unusual bonuses paid prior to bankruptcy should be forced to be returned to the firm for the benefit of unsecured creditors. **Considering the power that Chapter 11 executives have, post-bankruptcy pay should always be set by the post-bankruptcy board.**



Proposal to Expand Student Loan Dischargeability

John Rao, National Consumer Law Center

1. 11 U.S.C. § 523(a)(8) currently provides that the discharge an individual debtor receives does not discharge a debt:

    523(a) Exceptions to discharge--

    . . .

    (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for--

    (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or

    (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or

    (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual;

2. My proposal is to turn back the clock and give student loan borrowers the chance for a bankruptcy discharge, similar to what debtors had before the 1990 and 1998 amendments to section 523(a)(8) that eliminated the repayment time period after which discharge could be granted without proving undue hardship (a timeline of the statutory changes is provided below). Section 523(a)(8) should be replaced with:

    (8) for an educational loan made, insured, or guaranteed by a governmental unit, that first became due after seven years before the filing of the petition, unless excepting such debt from discharge under this paragraph will impose a hardship on the debtor or a dependent of the debtor.

3. Reasons why this change is needed:

    a. The gravity of the student loan debt problem cannot be overstated. Americans now owe over $1.7 trillion in student loan debt, more than they do for auto loans, credit cards, or any other non-mortgage debt. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, https://www.federalreserve.gov/releases/g19/current/ (last visited July 30, 2021). Student loan debt has become a key factor for many people who are considering when or whether to start small businesses, buy homes, or start families. Student loan debt is a factor not only for people who are entering the workforce for the first time, but also for those who are seeking to enter retirement.

b. Our bankruptcy system is intended to help those burdened with debt and yet we do not allow it to give relief for the debt many struggle with the most. It is like having a health care system that is not allowed to treat life-threatening and severe illnesses, that turns away those most in need of its services. The Bankruptcy Code's hope for a fresh start does not exist for those burdened with student loan debt.

c. I want to be clear that my proposal is not intended to solve the entire student debt problem. Of course, other solutions are needed. But this small change does not depend upon adoption of broader proposals, and it could help move the ball on broader reform.

d. You can make this change and truly transform the lives of debtors overwhelmed by student loan debt. Take, for example, Karen in Arkansas. Over 30 years ago, she got a $10,244 student loan to pay for a worthless degree no employer would recognize. After forbearances, wage garnishments, and payments made from her low-paying jobs, she has paid $19,552 on the loan. But she still owes, due to capitalized interest, over $106,000. She has no path to getting out of debt. Unlike other debt, statute of limitations and being judgment-proof do not matter. She will face collection efforts the rest of her life, including garnishment of her Social Security benefits. While these collection efforts will be an immense burden on Karen, they will not benefit the student loan program or other taxpayers as the administrative costs of collection will outweigh any meaningful recovery.

e. And yes, government student loans are different (i.e., minimal underwriting, public purpose) and deserve some level of protection from discharge, but not an outright ban on discharge. Undue hardship discharge is effectively no right at all because the barriers to access (litigation costs, burden of proof) are insurmountable – less than 0.1% of debtors seek an undue hardship discharge. Iuliano, J, An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard, American Bankruptcy Law Journal, 86(3) (2012).

f. We have long encouraged individuals of all ages to pursue higher education as a path to success. They are told that incurring student loan debt will give them a better chance at achieving their goals. We also encourage individuals to start businesses and to take chances in other entrepreneurial endeavors. The government even financially supports a number of loan programs with laudable goals similar to the student loan program, such as programs for veterans, farmers, small business owners, and home buyers. With all of these programs, we know that some individuals will fail. However, our bankruptcy laws treat student borrowers much more harshly – the business entrepreneur is given an opportunity for a fresh start while the student borrower is given no margin of error and is denied the right to a bankruptcy discharge.

g. This harsh treatment of student borrowers in financial distress in our bankruptcy system was not the result of careful analysis and thoughtful policy debate. Instead it was based simply on the false premise that student borrowers were more likely to abuse the bankruptcy system, even compared to other consumers with debts owed to the government. No evidence to support this premise existed when the law was first changed to limit student loan dischargeabilty or at the time of subsequent amendments.

h. Some argue the current policy is justified because student loans help borrowers obtain a college degree, which is an asset that will guarantee future income. This ignores the many student borrowers struggling with debt who never completed their schooling or obtained a degree. Even those borrowers who obtain a degree run into unexpected life traumas or other circumstances that prevent them from having incomes sufficient to repay their student loans.

i. Decades of mounting student loan indebtedness can have a drastic impact on an individual's future access to credit, employment opportunities, and housing. It can impose a substantial emotional burden on the debtor as well.

j. The focus of my proposal is on those who will never be able repay this debt. We provide no hope for these borrowers, or incentive for them to make payments, as their debt continues to grow due to the failed policies that capitalize interest and impose collection fees that may be as high as 25% of outstanding principal and interest.

k. The Department of Education convinced Congress in 1998 that the temporal ground for discharge (the seven-year waiting period) should be eliminated because administrative income-driven repayment ("IDR") plans would provide alternative relief for payment-troubled borrowers, and that borrowers can still get a bankruptcy discharge by proving undue hardship. We now know that this was a failed policy decision.

    i. The Department and its servicers' aggressive and costly litigation tactics have failed to facilitate resolution of bankruptcy discharge proceedings and have actually deterred borrowers from even trying to get an undue hardship discharge. Barely 0.1% of student loan debtors in bankruptcy seek an undue hardship discharge, and those that do are far more likely to be forced to go to trial to get a decision in their cases as compared to other civil litigation. Iuliano, J, An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard, American Bankruptcy Law Journal, 86(3) (2012); National Consumer Law Center, The Truth About Student Loans and the Undue Hardship Discharge, April 2013, available at: https://www.studentloanborrowerassistance.org/wp-content/uploads/2007/03/iulianoresponse.pdf

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> I have seen no evidence which convinces me of the need for a remedy as discriminatory and as inappropriate as section 439a of the Higher Education Act. I do not believe that bankruptcies involving student loans are increasing at such a rate as to require a provision this drastic, nor am I convinced that young debtors are declaring bankruptcy for the main purpose of 'ripping off' the government by not paying back their student loans. H.Rep. 95-595, 160, 1978 U.S.C.C.A.N. 5963, 6121.

Even representatives of the banking industry supported the repeal. The Judiciary Committee heard the following from Walter W. Vaughan, of the American Bankers Association and Consumer Bankers Association task forces on bankruptcy:

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After consideration of the GAO study and other compelling evidence that student borrowers were not abusing the bankruptcy system and that student loan debt should not be treated differently, the House Judiciary committee voted in favor of the repeal and rejected an amendment that would have made educational loans nondischargeable.

4. **1978 Code.** Despite evidence that stories of abuse were perception rather than reality, *see e.g.*, Kurt Wiese, *Discharging Student Loans in Bankruptcy: The Bankruptcy Court Tests of 'Undue Hardship*, 26 ARIZ. L. REV. 445, 446 (1984) (alleged student loan discharge problem was created by media), however, in 1978 Congress ultimately incorporated the general framework of the earlier Higher

Education Act amendment, providing for discharge after a five-year repayment period or upon proof of undue hardship, into the Bankruptcy Code.

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7. **1990 Amendments.** The Federal Debt Collection Procedures Act of 1990 (included in Crime Control Act of 1990), Pub. L. No. 101–647, § 3621(2), 104 Stat. 4933, Nov. 29, 1990, amended the repayment time period before a loan could be discharged from five years to seven years. Also in 1990, the Student Loan Default Prevention Initiative Act of 1990, Pub. L. No. 101–508, § 3007(b), 104 Stat. 1388–28, amended section 1328 to add debts covered by section 523(a)(8) to those that are nondischargeable in Chapter 13 cases.

8. **1998 Amendment.** The Higher Education Amendments of 1998, Pub. L. No. 105-244, § 971, 112 Stat. 1837, Oct. 7, 1998 amended section 523(a)(8) to eliminate the ability to discharge student loans after seven years in repayment, leaving only discharge upon proof of undue hardship. A House report described the change as follows:

   > The conferees, in the effort to ensure the budget neutrality of this bill, adopted a provision eliminating the current bankruptcy discharge for student borrowers after they have been in repayment for seven years. The conferees note that this change does not affect the current provisions allowing any student borrower to discharge a student loan during bankruptcy if they can prove undue economic hardship. The conferees also note the availability of various options to increase the affordability of student loan debt, including deferment, forbearance, cancellation and extended, graduated, income-contingent and income-sensitive repayment options. H.R. REP No. 105-750, Part G, at 408 (1998).

9. **2005 Amendment.** Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, Oct. 17, 2005, added a new exception to discharge for qualified education loans in subsection (a)(8)(B), making most private student loans nondischargeable.

Proposal to Expand Student Loan Dischargeability

John Rao, National Consumer Law Center

1. 11 U.S.C. § 523(a)(8) currently provides that the discharge an individual debtor receives does not discharge a debt:

   > 523(a) Exceptions to discharge--
   > . . .
   > (8) unless excepting such debt from discharge under this paragraph would impose an undue hardship on the debtor and the debtor's dependents, for--
   >
   > (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
   >
   > (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
   >
   > (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual;

2. My proposal is to turn back the clock and give student loan borrowers the chance for a bankruptcy discharge, similar to what debtors had before the 1990 and 1998 amendments to section 523(a)(8) that eliminated the repayment time period after which discharge could be granted without proving undue hardship (a timeline of the statutory changes is provided below). Section 523(a)(8) should be replaced with:

   > **(8) for an educational loan made, insured, or guaranteed by a governmental unit, that first became due after seven years before the filing of the petition, unless excepting such debt from discharge under this paragraph will impose a hardship on the debtor or a dependent of the debtor.**

3. Reasons why this change is needed:

   a. The gravity of the student loan debt problem cannot be overstated. Americans now owe over $1.7 trillion in student loan debt, more than they do for auto loans, credit cards, or any other non-mortgage debt. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, https://www.federalreserve.gov/releases/g19/current/ (last visited July 30, 2021). Student loan debt has become a key factor for many people who are considering when or whether to start small businesses, buy homes, or start families. Student loan debt is a factor not only for people who are entering the workforce for the first time, but also for those who are seeking to enter retirement.

b. Our bankruptcy system is intended to help those burdened with debt and yet we do not allow it to give relief for the debt many struggle with the most. It is like having a health care system that is not allowed to treat life-threatening and severe illnesses, that turns away those most in need of its services. The Bankruptcy Code's hope for a fresh start does not exist for those burdened with student loan debt.

c. I want to be clear that my proposal is not intended to solve the entire student debt problem. Of course, other solutions are needed. But this small change does not depend upon adoption of broader proposals, and it could help move the ball on broader reform.

d. You can make this change and truly transform the lives of debtors overwhelmed by student loan debt. Take, for example, Karen in Arkansas. Over 30 years ago, she got a $10,244 student loan to pay for a worthless degree no employer would recognize. After forbearances, wage garnishments, and payments made from her low-paying jobs, she has paid $19,552 on the loan. But she still owes, due to capitalized interest, over $106,000. She has no path to getting out of debt. Unlike other debt, statute of limitations and being judgment-proof do not matter. She will face collection efforts the rest of her life, including garnishment of her Social Security benefits. While these collection efforts will be an immense burden on Karen, they will not benefit the student loan program or other taxpayers as the administrative costs of collection will outweigh any meaningful recovery.

e. And yes, government student loans are different (i.e., minimal underwriting, public purpose) and deserve some level of protection from discharge, but not an outright ban on discharge. Undue hardship discharge is effectively no right at all because the barriers to access (litigation costs, burden of proof) are insurmountable – less than 0.1% of debtors seek an undue hardship discharge. Iuliano, J, An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard, American Bankruptcy Law Journal, 86(3) (2012).

f. We have long encouraged individuals of all ages to pursue higher education as a path to success. They are told that incurring student loan debt will give them a better chance at achieving their goals. We also encourage individuals to start businesses and to take chances in other entrepreneurial endeavors. The government even financially supports a number of loan programs with laudable goals similar to the student loan program, such as programs for veterans, farmers, small business owners, and home buyers. With all of these programs, we know that some individuals will fail. However, our bankruptcy laws treat student borrowers much more harshly – the business entrepreneur is given an opportunity for a fresh start while the student borrower is given no margin of error and is denied the right to a bankruptcy discharge.

g. This harsh treatment of student borrowers in financial distress in our bankruptcy system was not the result of careful analysis and thoughtful policy debate. Instead it was based simply on the false premise that student borrowers were more likely to abuse the bankruptcy system, even compared to other consumers with debts owed to the government. No evidence to support this premise existed when the law was first changed to limit student loan dischargeabilty or at the time of subsequent amendments.

h. Some argue the current policy is justified because student loans help borrowers obtain a college degree, which is an asset that will guarantee future income. This ignores the many student borrowers struggling with debt who never completed their schooling or obtained a degree. Even those borrowers who obtain a degree run into unexpected life traumas or other circumstances that prevent them from having incomes sufficient to repay their student loans.

i. Decades of mounting student loan indebtedness can have a drastic impact on an individual's future access to credit, employment opportunities, and housing. It can impose a substantial emotional burden on the debtor as well.

j. The focus of my proposal is on those who will never be able repay this debt. We provide no hope for these borrowers, or incentive for them to make payments, as their debt continues to grow due to the failed policies that capitalize interest and impose collection fees that may be as high as 25% of outstanding principal and interest.

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