Bankruptcy Appeal to Watch: Robert Murphy v. Educational Credit Management Corporation
1st Circuit Court of Appeals Docket No. 14-1691
Oral Arguments Schedule: December 10, 2015
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Bankruptcy laws allow companies to smoothly reorganize, but not college graduates burdened by student loans.[1] As bankruptcy attorneys, we often discuss student loan debt with our clients[2] and, for the most part, our advice must be that there is no realistic way to discharge student loan debt. Aside from the high-threshold legal standard, there are the practical reasons:

- Financing an adversary proceeding ("AP") to discharge student loans requires a rather large legal retainer from an already cash-strapped debtor;
- The AP will include time-intense discovery, motion practice, and a trial; and
- As a policy, public and private student loan creditors refuse to settle or allow for the discharge of student loans.

The above realities of student loan dischargeability litigation often make it unfeasible or just unaffordable to bring the action. However, even if the debtor overcomes the above three realities, what lies ahead is an untenable legal standard for most debtors. The well-known language but mostly undefined legal standard for student loan dischargeability is:

> A debtor may not discharge an educational loan "unless excepting such debt from discharge . . . would impose an undue hardship on the debtor and the debtor's dependants." 11 U.S.C. § 523(a)(8). The test boils down to one question: "Can the debtor now, and in the foreseeable future, maintain a reasonable, minimal standard of living for the debtor and the debtor's dependents and still afford to make payments on the debtor's student loans?" In re Hicks, 331 B.R. 18, 31 (Bankr. D. Mass. 2005).

The test is based upon the "totality of circumstances" which means each case is determined on a fact-by-fact basis and can lead to unpredictability. The current case on appeal Robert Murphy v. Educational Credit Management Corporation may open the door for a new test, or definition for "undue hardship":

Facts: Debtor is a 63-year old married man in good health. He has been unemployed since 2002, despite searching. Between 2001 and 2007, Debtor took out twelve (12) college education loans for his three now-grown children totaling $242,697.90 (current balance). As for other assets, the debtor's wife worked as a teacher's aid netting less than $14,000 a year, Debtor liquidated his retirement accounts for living expenses, and their house was underwater and in foreclosure. Despite receiving the benefit, Debtor's children are not debtor's on the student loans and thus not responsible for repaying the student loan debt. Within Debtor's Chapter 7 proceeding, Debtor filed an Adversary Proceeding to discharge the student loan debt. After a trial, the Bankruptcy Court denied a discharge based upon three factors:

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[1] Robert Reich, American Economist born June 24, 1946.
[2] Over Forty Million Americans carry student loan debt according to a 2014 analysis from credit bureau Experian.

1. Debtor is well-educated and has held high-earning jobs in the past;
2. While he is near, Debtor is not yet at the age of retirement; and
3. Since his 3 children are grown, Debtor is not burdened with debts relating to raising kids.

Procedural History:
Trial: After AP trial, Bankruptcy Court ruled that the student loans were not dischargeable.
Direct Appeal to the U.S. District Court: Bankruptcy Court denying dischargeability of student loans affirmed by a decision issued by J. Zobel on May 21, 2014.
Appeal to First Circuit: Briefs Filed and oral arguments scheduled for Nov. 5, 2015

Summary of Debtor's Brief and Argument:

Main Brief *Pro Se* [9/22/2014]

Debtor takes issue with the fact that both the Bankruptcy Court and District Court required him to demonstrate "truly exceptional circumstances" to justify an undue hardship, usually requiring a serious illness or large number of dependents. However the term "truly exceptional" is undefined and does not appear in either "undue hardship" test employed by the First Circuit. Debtor relies upon the fact that his schedules show a deficit income, lack of opportunity to find employment (although disputed by the student loan servicer), and no real chance of him finding income in the future. The majority of his argument is that he has tried to gain employment, tried to repay the debt, but just cannot secure employment and has no real shot at repaying the loans, especially since he is approaching retirement. The Debtor also argues that he's shown a good faith effort to repay since he repaid $60,000 of the student loans over the years and made on-time payments, depleting his retirement accounts despite remaining unemployed.

Supplemental Brief *with Pro Bono Counsel* [7/22/2015]

Debtor filed a supplemental brief, after accepting pro bono counsel, and the Supplemental Brief advocates for the totality test, but also asks the First Circuit to rule that the *Brunner* Test has no application in this Circuit. Secondly, where Bankruptcy Courts currently require "truly exceptional circumstances," Debtor's Supplemental Brief request that the Court reject this high standard that is not required by Congress through the plain language of the Code, and is also not required under the "totality of circumstances" test. After detailing the ills and pitfalls of the harsh *Brunner* Test given a change in the laws and student loan repayment programs, Debtor advocates for the totality of circumstances test because it would narrow the Court's decision down to one single question: Can the debtor now, and in the foreseeable future, maintain a reasonable, minimal standard of living for the debtor and dependents and still afford to make student loan payments? In advocating for this approach, the Debtor argues that Congress's intent to prevent abuse will be met since each case will be examined thoroughly by the facts and abuse or lack of good faith can easily be sussed out by examining the debtors actions, efforts to repay, income and expenses.

Summary of Student Loan Servicer's Brief and Argument:

Main Brief [12/08/2014]
Supplemental Brief [10/27/2015]

Servicer argues that student loans, like any loan, are a calculated risk. The debtor chose the riskiest loans here because he loaned 12 large student loans on behalf of his children, when he was unemployed, in his late 50's, and his prospects of gaining employment with an income high enough to repay all the loans were slim to none. That is not an "undue hardship," but instead the debtor made a bad financial decision and took the risk of being involved in this very situation: still unemployed and unable to repay all the loans. More importantly, the debtor was 62 years old when he filed his Chapter 7 case and his adversary proceeding – certainly nearing the age of retirement, but in good health and able to work and still earn a good living. The Loan Servicer's argument may be considered "attacking the debtor" but in reality, people work well into their 70's, and a portion of the working class is underemployed. Despite the debtor being a former president of a company, and making a $165,000.00 salary, obtaining new employment at a lower salary certainly isn't unreasonable, nor unfeasible. The debtor in this case chose to remain unemployed, rather than underemployed, draining his savings and still take out well over $200,000 in student loans while unemployed.

The Servicer also suggests the facts are suspect given the timing and major risk involved. In fact, the Servicer suggests that the Debtor planned these circumstances: Borrow significant student loans while unemployed in his 50's so his children can attend college debt-free, remain unemployed but perform a half-hearted search (the servicer suggests the debtor only applied to CEO and executive-level jobs with no real chance of landing one), and in a few years try to discharge them in bankruptcy with a showing that the Debtor was still unemployed, nearing retirement and had no prospect of having enough money to repay the loans.
Lastly, the Servicer argues that the Debtor has not shown a good faith effort to repay the loans because he did not consolidate the federal loans, and has not applied for the Income Contingent Repayment Program (ICRP) offered by the feds. The servicer advocated for the First Circuit to adopt and continue to utilize the Brunner test because one of the factors is whether or not the debtor made a good faith effort to repay the student loans (i.e. consolidated the federal loans and applied for an income-based or contingent repayment program when hard times hit the debtor).

Summary of National Consumer Law Center Brief and Argument:

Amicus Brief [9/09/2015]

As the consumer law center states, ironically, those debtors who are most likely to prevail (permanently disabled, permanently unemployed, chronically ill) are least likely to afford representation, creating a court access problem and making a student loan dischargeability action a formidable task. Simply, the consumer law center advocates for a new test entirely – one that is simple, based upon the current employment, illness and realistic future of the debtor, and not upon conjecture or unsubstantiated optimism (a sliver of hope a person may have to seek employment in the future before attaining retirement age).

The consumer law center's request is simply based upon a shift and change in the law. The current "undue hardship" standard is often called the Brunner test, after it was espoused in 1987 in *Brunner v. New York State Higher Education Services Corp.*, 831 F. 2d 395 (2d Cir. 1987). In 1987, student loans were automatically dischargeable in bankruptcy, without proving undue hardship, if debtors simply waited five years after their loans first became due. The *Brunner* Test was created to prevent abuse – to prevent debts from seeking a premature discharge soon after the loans became due without demonstrating an inability to pay. Thus, the harsh *Brunner* Test was created to stop abuse and prevent bad faith student loan discharges.

Ultimately, the consumer law center urges the First Circuit to eschew the *Brunner* Test and other tests, and instead, clearly define a new test that answers the simple question: Can the debtor maintain a reasonable, not extraordinary, standard of living after bankruptcy while also repaying student loan debts?

Summary of United States Brief and Argument:

Amicus Brief [10/29/2015]

The United States, while using a practical fact-based argument, certainly has much to lose since it owns or services 90% of student loans, and created all the income-based or contingent repayment plans for consolidated federal student loans. The U.S. points to some key facts that weigh against the debtor:

- Murphy was a high earner and had a salary of $165,000.00 until 2002, when he was terminated.
- Between 2001 and 2007, Murphy took out twelve federal student loans totaling $220,765.00, despite being unemployed since 2002.
- Murphy never applied for an income-contingent repayment program, but instead, let the student loan fall into default.
- Murphy remained unemployed since 2002 despite being healthy and able to work.

Not surprisingly, the U.S. advocates for the Second Circuit *Brunner* Test, a part of which is to examine whether the debtor has attempted to repay his loans in good faith (i.e. consolidated and used an income-based or contingent repayment program). The U.S.'s agenda is clearly evident in its main argument. While *Brunner* and the "totality of circumstances" test both focus on whether the Debtor has sufficient present and future income/resources to maintain a reasonable living standard while repaying the loan, *Brunner* goes a step further. By requiring good faith efforts to repay their student loan, *Brunner* better effectuates Congress's overriding purpose of ensuring borrowers repay their student loans and do not utilize bankruptcy as an expedient way to discharge student loans.

The U.S.'s argument is historically-based, and also utilizes the plain language, but certainly advocates for a test that almost requires that student loan holders consolidate their student loans, repay for many years, and when facing hardship, utilize their income-based or contingent repayment programs.

<u>Summary of Rafael I. Pardo Brief and Argument</u>:
Robert T. Thompson Professor of Law at Emory University School of Law
Teaches bankruptcy, contracts, and secured transactions

<u>Amicus Brief</u> [8/18/2015]

Professor Pardo's reasoning is simple: the plain meaning of "undue hardship" simply asks the court to determine what effect that repayment of a pre-bankruptcy debt will have on the debtor. Specially, whether the repayment of the pre-bankruptcy debt will impose an excessive hardship on the debtor or a dependent of the debtor.

Professor Pardo's argument is particular and unique in that he analyzes the only other parts of the bankruptcy code where the term "undue hardship" is used: reaffirmation agreements [11 U.S.C. §524(c)]; and discharge for Chapter 13 debtors who fail to complete their repayment plans [11 U.S.C. § 1328(b)]. In the context of the reaffirmation agreement, courts will not approve the debtor's agreement to remain personally liable on a dischargeable debt unless it won't impose an undue hardship, meaning the effect that repayment will have on the debtor's fresh start. The reaffirmation provision further provides for a presumption of undue hardship (inability to repay the debt) over the sixty-day period where the reaffirmed debt payments exceed the debtor's monthly disposable income. To even have the reaffirmation agreement approved, the debtor must rebut the presumption by identifying the source of additional funds to pay the reaffirmed debt. In the Chapter 13 context, the code provides for a "hardship discharge" even if the Debtor has failed to complete his Chapter 13 repayment plan if the debtor can prove he is not responsible for having created his inability to repay and thus that "the request is justified."

As expected, Professor Pardo's argument is academic but certainly sound and persuasive. Somehow, through dictum, the First Circuit has espoused the student loan "undue hardship" to mean a significant illness or serious burden to a debtor with many dependents. Yet, the "undue hardship" for a reaffirmation or Chapter 13 hardship discharge is simply what effect will not discharging this debt have on the debtor's fresh start and can he show he is not responsible for creating his own inability to pay. In my own opinion, Professor Pardo's argument wins the day; however, given the facts of Debtor Robert Murphy, the First Circuit can still affirm the lower court's decision where he loses because of his many years of unemployment, and turning down lower paying jobs and only seeking executive/management positions. It's possible a court reviewing Murphy's employment history could find against him on whether or not he created his own hardship/inability to pay.

Conclusion.

Murphy will be an important case, whether it falls in debtor's favor or the student loan lenders' favor. This case requires the First Circuit to delve into a mostly undeveloped area of law that truly effects a majority of the population, and certainly will since debtors are incurring more student loan debt, not less. Since the standard of review is *de novo*, the Court has the power to create a new test, or develop the current standard for student loan dischargeability that would at a minimum provide guidance on the area. Whether the First Circuit adopts the "totality of the circumstances" test, the <u>Brunner</u> Test, or espouses a new test, the dischargeability test will no longer reply upon dictum, but the Murphy case. The result: bankruptcy attorneys will likely be able to better advise clients on the odds when discussing a potential student loan dischargeability adversary proceeding.

Arguments are before the First Circuit Court of Appeals on December 10, 2015.