The Disconnect of Student Loan Dischargeability in Bankruptcy [*In re Engen*, 561 B.R. 523 (Bankr. D. Kan. 2016).]

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I. INTRODUCTION

Student loan debt remains at an all-time high and is now the second largest category of consumer debt, surpassing both credit card and auto loans.[1] While the amount of student loan debt continues to grow, it remains a major category of debt that is not dischargeable through bankruptcy.[2] Although federal bankruptcy protections were first enacted to protect debtors, the nondischargeability of student loan debt "may create a virtual debtors' prison, one without physical containment, but assuredly a prison of emotional confinement."[3]

One of the major problems with student loan debt, in addition to not being dischargeable, is the fact that it is treated as general unsecured debt—sharing pro rata with all other unsecured creditors and generally receiving little to nothing in bankruptcy.[4] Many bankruptcy courts have used judicial discretion to get around the nondischargeability and non-priority nature of student loan debt.[5] The case of *In re Engen*,[6] from the Bankruptcy Court for the District of Kansas, serves as an example of the problem of student loan debt in bankruptcy. There, Judge Berger reached a unique solution—

1. *See* Zach Friedman, *Student Loan Debt Statistics in 2018: A $1.5 Trillion Crisis*, FORBES (June 13, 2018), https://www.forbes.com/sites/zackfriedman/2018/06/13/student-loan-debt-statistics-2018/#254422007310. The largest category of consumer debt is mortgage debt. *Id.*

2. *See* 11 U.S.C. § 523(a)(8) (2018). Discharge of indebtedness is one of the major advantages of bankruptcy and allows certain debts to be wiped away, giving the debtor a fresh start. *See id.* §§ 727, 1328.

3. *In re* Engen, 561 B.R. 523, 550 (Bankr. D. Kan. 2016).

4. *See* Margaret Howard, *A Bankruptcy Primer for the Family Lawyer*, 31 FAM. L.Q. 377, 382–83 (1997). "Pro rata" means general unsecured creditors share the remaining portion of the bankruptcy estate in proportion to the size of their bankruptcy claims. *Id.* ("The pro rata portion each claimant receives is determined by simple arithmetic—the amount available is divided by the total amount of general unsecured claims. For example, if $1,000 remains in the estate and the debtor owes $10,000 to the holders of general unsecured claims, each claim is paid 10 percent.").

5. *See, e.g.*, *In re* Edwards, 561 B.R. 848, 851 (Bankr. D. Kan. 2016) (discharging private student loan debt for undue hardship); *In re* Murray, 563 B.R. 52, 54 (Bankr. D. Kan. 2016) (discharging student loan interest).

6. 561 B.R. 523 (Bankr. D. Kan. 2016).

allowing student loan debt to be classified separately from other unsecured creditors and given preferential treatment.[7]

The *Engen* case highlights the disconnect between the treatment of student loans and other debts in bankruptcy.[8] This disconnect was primarily caused by the gradual shift in student loan dischargeability amidst growing concerns of abuse of the bankruptcy system.[9] The growing student debt crisis creates a need to readdress the treatment of student loan debt in consumer bankruptcies.[10] Various options are available to reform the Bankruptcy Code and improve the treatment of student loan debt.[11] Without adequate reform, bankruptcy courts will be forced to continue to create equitable solutions to resolve this problem, much like the court in *Engen*.[12]

II. BACKGROUND

A. Legal Background

A Chapter 13 bankruptcy allows a debtor to pledge income earned after the bankruptcy filing to pay pre-petition debts.[13] The debtor proposes a three to five year repayment plan which must be confirmed by the court.[14] To be confirmed, the plan must pay all secured and priority unsecured claims and must pledge "all of the debtor's projected disposable income" to the payment of unsecured creditors.[15] Upon successfully completing the plan, the debtor receives a discharge of the remaining unsecured debt, subject to specific exceptions.[16] Categorically nondischargeable debts include taxes, domestic support obligations, and student loans.[17] Many nondischargeable debts, such as taxes and domestic support obligations, are also priority debts which will be paid out in full *before* any payment is made

7. *Id.* at 551.
8. *Id.* at 540–50.
9. *See infra* notes 52–58 and accompanying text.
10. *See* Annie Nova, *Despite the Economic Recovery, Student Debtors' 'Monster in the Closet' Has Only Worsened*, CNBC (Sept. 22, 2018), https://www.cnbc.com/2018/09/21/the-student-loan-bubble.html.
11. *See infra* Section IV(B).
12. *Engen*, 561 B.R. at 551.
13. *Id.* at 530.
14. *Id.*; *see* 11 U.S.C. §§ 1321, 1325 (2018).
15. *Engen*, 561 B.R. at 530 (quoting 11 U.S.C. § 1325(b)(1)(B) (2016)).
16. *Id.* at 530.
17. *See* 11 U.S.C. §§ 1328(a), 523(a) (2018). There is an exception to the nondischargeability of student loans debts where "excepting such debt from discharge . . . would impose an undue hardship on the debtor and the debtor's dependents . . . ." 11 U.S.C. § 523(a)(8). For a general overview of the undue hardship test, see Aaron N. Taylor & Daniel J. Sheffner, *Oh, What a Relief it (Sometimes) is: An Analysis of Chapter 7 Bankruptcy Petitions to Discharge Student Loans*, 27 STAN. L. & POL'Y REV. 295, 304–307 (2016).

to general unsecured creditors; however, student loans are not priority debts and are generally pooled with other general unsecured debts.[18]

The Bankruptcy Code ("Code") specifically allows debtors to distinguish and discriminate between various unsecured creditors within a Chapter 13 plan.[19] The requirements for separate classification and discrimination between creditors are that the plan "not discriminate unfairly"[20] and that "dissimilar claims [are not] classified together."[21] Many courts have recognized "the nondischargeable nature of student loan debt is sufficient to allow separate classification."[22] Notwithstanding the separate classification, a plan that proposes to allow some unsecured creditors to receive more than others does not automatically mean that the discrimination is unfair.[23]

Bankruptcy courts have used many different tests to determine if discrimination is "unfair."[24] Many of these tests are taken from Chapter 11 cases, because both Chapters 11 and 13 allow separate classification of general unsecured creditors as long as the discrimination is not "unfair"; however, the analysis under Chapter 13 is typically much more lenient than under Chapter 11.[25] The Multifactor Approach is the most common test used, and is composed of four parts: "(1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination."[26] Bankruptcy courts in the Tenth Circuit have also used the Baseline Test, which utilizes four principles: "(1) equality of distribution; (2) nonpriority of student loans; (3) mandatory versus optional contributions; and (4) the debtor's fresh start."[27] In the Chapter 13 context, these tests often do not reflect the reality of the

18. *See* 11 U.S.C. § 507(a) (2016).

19. *Engen*, 561 B.R. at 532; *see also* 11 U.S.C. § 1322(b)(1) (2016).

20. *Engen*, 561 B.R. at 533 (quoting 11 U.S.C. § 1129(b)(1) (2018)).

21. *Engen*, 561 B.R. at 532–33 (quoting 7 COLLIER ON BANKRUPTCY ¶ 1122.03[1], at 1122-6 to 1122-7 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2016); *see also* 11 U.S.C. §§ 1129(b)(1), 1122(a) (2018).

22. *Engen*, 561 B.R. at 533 ("[C]ourts have allowed the separate classification of debts that would be nondischargeable in a chapter 7 case, reasoning that Congress itself indicated a policy choice to distinguish such debts.") (quoting 8 COLLIER ON BANKRUPTCY 1322.05[2], at 1322-18–19 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2016)); *see also In re* Gregg, 179 B.R. 828 (Bankr. E.D. Tex. 1995); *In re* Boggan, 125 B.R. 533 (Bankr. N.D. Ill. 1991); *In re* Freshley, 69 B.R. 96 (Bankr. N.D. Ga. 1987).

23. *Engen*, 561 B.R. at 533.

24. *Id.* at 535–36. Different tests used by courts to determine if discrimination is "unfair" include the Strict Approach, Flexible Approach, Balance Approach, Reasonableness Approach, Bright-Line Approach, Percentage of Repayment Approach, Interest of Debtor Approach, and Multifactor Approach. *Id.*

25. *Id.* at 534.

26. *Id.* at 537; *see also In re* Lesser, 939 F.2d 669 (8th Cir. 1991).

27. *Engen*, 561 B.R. at 537; *see also In re* Bentley, 266 B.R. 229 (B.A.P. 1st Cir. 2001).

discretion of the bankruptcy judge and are sometimes used only as starting points for the court's determination of what is reasonable in the consumer bankruptcy setting.[28]

B. Case Description

On February 4, 2015, Mark and Maureen Engen ("Debtors") filed a voluntary petition for Chapter 13 bankruptcy relief.[29] At the time of the bankruptcy filing, the Debtors owed $213,751 in secured debt, $25,381 in priority unsecured debt, $64,791 in student loan debt, and $26,328 in other general unsecured debt.[30] The plan also created a special class of creditors for the student loan debt, which would be paid before any other general unsecured debt.[31] The trustee objected to the confirmation of the plan, alleging that the separate classification of the student loan debt unfairly discriminated against other general unsecured creditors, in violation of § 1322(b)(1).[32]

III. COURT'S DECISION

Judge Berger, after first rejecting the usefulness of various tests used by other courts, used the Baseline Test as a starting point for his analysis before continuing into a broader discussion of the policy rationale supporting separate classification.[33] First, the court recognized that the Debtors made significant payments to general unsecured debtors *before* filing for bankruptcy through a voluntary debt management plan.[34] Although Judge Berger made it clear that "the Court [did] not solely hang its hat on Debtors' prepetition payments," any discrimination under the plan was presumably fair in light of these payments and the circumstances in this case.[35] Interestingly, the court did not end its analysis after these factual determinations, but continued on because "other considerations warrant[ed] separate classification of Debtors' Student Loan Claims."[36]

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28. *Engen*, 561 B.R. at 538.
29. Voluntary Petition, *In re* Engen, 561 B.R. 523 (Bankr. D. Kan 2016) (No. 15-20184).
30. *Engen*, 561 B.R. at 529.
31. *Id.*
32. *Id.* at 527. The bankruptcy trustee is an individual appointed by the court that represents the bankruptcy estate and ensures the value of the estate is maximized for the benefit of the unsecured creditors. *See* 11 U.S.C. § 323 (2018).
33. *Engen*, 561 B.R. at 538–39.
34. *Id.* at 539. Before filing for bankruptcy, the Debtors paid $78,629.98 to non-student loan unsecured creditors (paying down $61,692.73 of principal due to the accrual of additional interest and penalties). *Id.* This represented a dividend of 83 percent, paid to other general unsecured creditors and to the detriment of the student loan creditors. *Id.*
35. *Id.* at 539–40.
36. *Id.* at 540.

Next, the court addressed the other policy considerations warranting separate classification.[37] Although student loans do not receive priority status, their nondischargeable nature supports a finding that these claims receive otherwise favorable treatment.[38] The rationale behind the nondischargeable status of student loans is largely the self-interest of the government in protecting their status as a guarantor or lender.[39] As the court pointed out, "allowing Debtors to treat their Student Loan Claims favorably ahead of other general unsecured creditors furthers Congressional intent and protects the government's and the student loan program's fiscal health."[40] Additionally, because the unique nature of student loans relies on the debtor's future income for repayment, the court believed a repayment plan under Chapter 13 was a perfectly appropriate means to achieve repayment.[41]

The court also recognized separate classification of student loans was supported by the idea of a debtor's "fresh start."[42] One of the primary goals of consumer bankruptcy is to give "honest, but unfortunate debtor[s] a fresh start."[43] Allowing debtors to give favorable treatment to student loans in a Chapter 13 plan supports Congress's intent to have more debtors utilize Chapter 13 to achieve their fresh start.[44] If debtors were not able to discriminate in favor of student loan debt, they may face more debt at the completion of the plan than when they initially filed for bankruptcy due to the accrual of additional interest.[45] Finally, the court acknowledged:

'[T]he Code specifically permits debtors to cure defaults and maintain payments on long-term debts on which the final payment is due after the final payment of the plan, [and] a number of courts have permitted debtors to separately classify student loan debts for the purpose of providing them that specified treatment in a plan.'[46]

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37. *Id.* at 540–50.

38. *Id.* at 540.

39. *Engen*, 561 B.R. at 541; *see also In re* Knowles, 501 B.R. 409, 418 (Bankr. D. Kan. 2013).

40. *Engen*, 561 B.R. at 541–42.

41. *Id.* at 541. Congress recognized the unique nature of student loans in the Bankruptcy Reform Act of 1978 when they opined that: "[E]ducational loans are different from most loans. They are made without business considerations, without security, without cosigners, and relying for repayment solely on the debtor's future increased income resulting from the education. In this sense, the loan is viewed as a mortgage on the debtor's future." *Id.* (quoting H.R. REP. NO. 95-595, at 133 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6094).

42. *Id.* at 543–44.

43. *Id.* at 543. Under Chapter 13, this fresh start is achieved both through the structured repayment of debt over the plan's commitment period, as well as the possibility of having remaining debts discharged. *See* 11 U.S.C. §§ 1322, 1328 (2018).

44. *Engen*, 561 B.R. at 543 ("Congress intended more debtors to seek relief under Chapter 13 instead of Chapter 7. Debtors not permitted to favor student loans in Chapter 13 risk not receiving a fresh start and may elect conversion to Chapter 7 in which unsecured creditors typically receive little to nothing.").

45. *Id.* at 541.

46. *Id.* at 544 (quoting 8 COLLIER ON BANKRUPTCY 1322.05[2][a], at 1322-20 (Alan N. Resnick & Henry J. Sommer, eds., 16th ed. 2016)).

The court found that because student loan claims are long-term debts and account for over seventy-one percent of the total unsecured debt, separate classification is proper under § 1322(b).[47] This, along with the nondischargeable status of the student loan claims and the voluntary prepetition payments in favor of other unsecured creditors, demonstrates that the separate classification of student loan claims does not discriminate unfairly.[48] As stated by Judge Berger, "[i]f bankruptcy is, in part, the art of compromise, then Debtors' Proposed Plan that fairly discriminates in favor of the Student Loan Claims is a permissible compromise under § 1322(b)(1)."[49]

IV. COMMENTARY

A. The Cause of the Disconnect

The above case highlights a significant and growing problem with student loan debt in bankruptcy and represents a sharp disconnect between nondischargeable debts and priority debts. Nondischargeable debts are generally either punitive in nature, such as debts wrongfully incurred through fraud or false pretenses, or supported by public policy reasons, such as child support obligations, alimony, or taxes.[50] Often, the same public policies that support certain debts being nondischargeable also supports accompanying priority status.[51] Student loan debt is one of the only debts not dischargeable for non-punitive reasons that is not identified as a priority.[52]

One of the major causes of this disconnect was the gradual progression of student loans towards nondischargeability.[53] Historically, student loans were not distinguished from general unsecured debts and were completely dischargeable, but Congress became concerned that student debtors would abuse the bankruptcy system and threaten the solvency of the student loan programs.[54] In 1978, § 523(a)(8) was added to the Code.[55] This provision prohibited the discharge of federal student loans that had been incurred

47. *Id.*
48. *Id.* at 544, 551.
49. *Id.* at 550.
50. *Engen*, 561 B.R. at 540; *see also* 11 U.S.C. § 523(a) (2018).
51. *See* 11 U.S.C. § 507(a) (including child/spousal support and taxes as priority debts).
52. *See* 11 U.S.C. § 523(a). Debts nondischargeable for punitive reasons include credit obtained under false pretenses, fraud, willful and malicious injury to another, and death or personal injury caused by the debtor's operation of a motor vehicle while intoxicated. 11 U.S.C. § 523(a)(2), (4), (6), (9). Debts nondischargeable for non-punitive reasons include taxes, domestic support obligations, and student loans. 11 U.S.C. § 523(a)(1), (5), (8).
53. *See infra* notes 54–59 and accompanying text.
54. *Engen*, 561 B.R. at 531.
55. Pub. L. No. 95-598, § 523, 92 Stat. 2549 (1978).

within five years preceding bankruptcy.[56] The nondischargeability period was later extended to seven years in 1990.[57] In 1998, the waiting period was removed completely, making government insured student loans nondischargeable.[58] The nondischargeability was fully expanded to include private student loans when Congress overhauled the Code in 2005.[59] At no point during this progression did Congress make corresponding revisions to student loan debt's priority status, likely because each step of the nondischargeability progression was too small by itself to warrant a change to the priority section.[60]

This disconnect, coupled with the ever-growing student loan debt, creates a need to readdress the treatment of student loan debt in consumer bankruptcies.[61] Various options are available to reform the Code, and without reform, the bankruptcy courts will be forced to continue judicially creating equitable solutions for student loan debt.[62] Regardless of the solution, this problem requires further review and oversight because it will only get worse as the overall level of student debt increases.

B. Resolving the Disconnect

Solutions are available to help alleviate this disconnect, many of which involve reforming the Code's treatment of student loan debt—such as giving priority status to student loans, restoring the dischargeability of student loans, or separate treatment of student loan debt.[63] Although some of these options would have beneficial aspects, they would likely have additional unintended consequences.[64] For instance, making student loans priority debts would likely do more harm than good for Chapter 13 debtors because Chapter 13 requires debtors to pay all priority debts in full within the term of the plan, which would likely be impossible for debtors with large student loan debt.

Another option would be to restore the dischargeability of student loan debt. The potential for abuse would still be present, but this potential could be reduced through imposing a longer waiting period—such as ten or fifteen years—and requiring sufficient payments during the waiting period. Many student loans qualify for income-based-repayment plans that allow a debtor

56. *Id.*
57. *See* Crime Control Act of 1990, Pub. L. No. 101-647, § 3621, 104 Stat. 4789 (1990).
58. *See* Higher Education Amendments Act of 1998, Pub. L. No. 105-244, § 971, 112 Stat. 1581 (1998).
59. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, § 220, 119 Stat. 23 (2005).
60. *See Engen*, 561 B.R. at 531.
61. *See* Friedman, *supra* note 1.
62. *See infra* Section IV(B).
63. *Cf.* 11 U.S.C. § 507, 523 (2018).
64. *See infra* note **Error! Bookmark not defined.** and accompanying text.

to pay a portion of their income for a period of twenty to twenty-five years and then forgive any remaining balance; however, this practice has significant tax consequences. When debt is cancelled or forgiven, it is treated as taxable income, creating a large tax bill for the debtor. Alternatively, debt that is discharged through bankruptcy is not included in the debtor's income and does not present any additional tax consequences. Thus, the forgiveness achieved after an income-based-repayment plan is not nearly as effective of a "fresh start" for the debtor as a bankruptcy discharge.

Likely, the best option for reform would be to create an entirely separate classification of student loan debt within the Code. Many courts have recognized that student loan debt is extremely different from other types of debt, not only in how the debt is incurred and in the amount of debt, but also in the policy rationale that supports its nondischargeability and preferred treatment. Similar to how courts have allowed separate classification and preferential treatment of student loan debt, the Code could be revised to include a separate classification of student loan debt that recognizes its unique nature. This separate classification would allow for preferential repayment of student loan debt before general unsecured creditors, but would not impose the requirement that it be paid in full during the term of a Chapter 13 plan. An alternative preferential treatment would be to allow student loan debt to be cured similar to long-term debts outside the plan—debtors would use the plan to catch up on amounts owed, and then would continue paying under the terms of the loan after the bankruptcy plan's completion. This would again allow the preferential payments before paying general unsecured debt and would not require full repayment during the plan's commitment period.

V. CONCLUSION

Judge Berger's analysis in *In re Engen* highlights the need for reform of the Code's treatment of student loan debt. Student loan debt is growing at an alarming rate and will likely have an increasingly large impact on consumer bankruptcies. If the treatment of student loan debt is not revised, many student debtors will be left without an avenue to improve their financial situation. Many options are available for addressing this issue through Code revisions, but these options have additional consequences that must be considered. If Congress does not readdress the treatment of student loan debt in bankruptcy, courts will be forced to continue finding equitable solutions to achieve the underlying objectives of bankruptcy. Judicial discretion would be an imperfect solution for student loan debt treatment, because while federal student loans compose a majority of all student loan debt, relying on judicial discretion would mean a debtor's treatment of their

student loan debt would be at the mercy of whichever jurisdiction in which they are filing bankruptcy. Judge Berger best described this need:

> Student loan creditors deserve separate classification in bankruptcy because the taxpayer-funded student loan system is critical to society's future welfare. It is one thing to not allow delinquent debtors an escape hatch from their student loans, but it is quite another to forbid debtors with limited resources from favoring a taxpayer backed nondischargeable obligation incurred for society's benefit.[65]

The clock is ticking. Student loan debt is rising along with the student loan default rate, and the number of individuals affected will only grow as Congress waits to reform this system. The growing amount of student loan debt means many consumers will be left without relief from massive student loan burdens. Reforming the Bankruptcy Code would provide much needed relief to this system and would preserve bankruptcy as a viable option to assist struggling debtors.

65. *Engen*, 561 B.R. at 550.