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## NOTE

### ENDING STUDENT LOAN EXCEPTIONALISM: THE CASE FOR RISK-BASED PRICING AND DISCHARGEABILITY

#### I. INTRODUCTION

The economics of higher education are in crisis: tuitions are soaring, with increases in college and law school costs outpacing inflation by 71% and 317%, respectively, from 1989 to 2009;<sup>1</sup> students are exiting college and graduate school more indebted than ever, as a 319% surge in average cumulative federal borrowing from 1990 to 2010 has transformed student loans into the largest source of consumer indebtedness after mortgages;<sup>2</sup> and defaults on this rising debt are mounting, with two-year default rates nearly doubling over the past five years.<sup>3</sup> To make matters worse, all of this comes as the value of higher education is being called into question. At the college level, some critics stress that the real pay of graduates has increased far less than tuition<sup>4</sup> while a growing chorus expresses concern over the meteoric rise of for-profit colleges, whose students take out more loans and experience dramatically higher default rates than average.<sup>5</sup> And the value proposition might be even more troubling at graduate schools, especially law schools, which have increased tuition at a rate four times that of wage

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<sup>1</sup> David Segal, *Law School Economics: Ka-Ching!*, N.Y. TIMES, July 17, 2011, at BU1; see also Tamar Lewin, *College Costs Keep Rising, Report Says*, N.Y. TIMES, Oct. 21, 2009, at A14.

<sup>2</sup> For growth in average federal borrowing, see DEP'T OF EDUC., STUDENT LOANS OVERVIEW: FISCAL YEAR 2013 BUDGET REQUEST R-22 (2012) [hereinafter STUDENT LOANS OVERVIEW]. On the status of student loans as the second-largest source of consumer indebtedness, see *Student Loan Debt History*, FED. RES. BANK OF N.Y., <http://www.newyorkfed.org/studentloandebt/> (last visited Oct. 27, 2012).

<sup>3</sup> See *FY 2010 2-Year Official National Student Loan Default Rates*, FED. STUDENT AID, <http://www2.ed.gov/offices/OSFAP/defaultmanagement/defaultrates.html> (last visited Oct. 27, 2012).

<sup>4</sup> See A. Gary Shilling, *How Recession Will Change University Financing*, BLOOMBERG (July 24, 2012, 6:30 PM), <http://www.bloomberg.com/news/2012-07-24/how-recession-will-change-university-financing.html>. While colleges might under deliver, those who have graduated from college nonetheless fare far better than those who have not. See Peter Coy, *Student Loans: Debt for Life*, BLOOMBERG BUSINESSWEEK (Sept. 6, 2012), <http://www.businessweek.com/articles/2012-09-06/student-loans-debt-for-life>.

<sup>5</sup> On the growth of for-profit institutions, see THOMAS D. SNYDER & SALLY A. DILLOW, DIGEST OF EDUCATION STATISTICS 2011, at 290 tbl.198 (2012). On their problems, see, for example, COMM. ON HEALTH, EDUC., LABOR, & PENSIONS, 112TH CONG., FOR PROFIT HIGHER EDUCATION, S. PRT. NO. 112-37 (Comm. Print 2012) [hereinafter HARKIN REPORT]; and Jean Braucher, *Mortgaging Human Capital: Federally Funded Subprime Higher Education*, 69 WASH. & LEE L. REV. 439, 457-58 (2012).

growth over the past two decades<sup>6</sup> and at least fifteen of which have been recently sued for reporting misleadingly sanguine employment statistics amid a grim legal job market.<sup>7</sup>

With returns sinking and tuitions, indebtedness, and defaults surging, the need for higher education financial reform is pressing. A natural starting point for such reform is the student loan market, the most significant source of higher education financing.<sup>8</sup> Indeed, federal student loan pricing practices contribute to the preceding problems by encouraging borrowers to assume debt that they are unlikely to be able to repay, and § 523(a)(8) of the Bankruptcy Code exacerbates the effects of such burdensome debt by allowing private and federal student loans to be discharged only upon a showing of “undue hardship.”<sup>9</sup> This Note therefore advocates a two-part overhaul of the student loan system, urging the federal government both to begin risk-rating its student loans and to repeal § 523(a)(8).

The envisioned risk-rating framework calls for the federal government to price its student loans according to the institution a borrower attends and the course of study pursued at that institution. In thereby differentiating among borrowers, the government will mitigate each of the problems of higher education economics identified above. First, defaults will fall as higher interest rates dissuade certain borrowers from taking on what will likely become unmanageable debts. Second, tuitions and student indebtedness will sink among the institutions that set tuitions in response to loan availability and that are confronted with reduced loan supply as the cost of their loans increases amid poor repayment prospects. Such institutions include for-profit colleges (where students default at a rate nearly three times that of other students<sup>10</sup>

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<sup>6</sup> See *Hedlund v. Educ. Res. Inst., Inc.*, 468 B.R. 901, 907 (D. Or. 2012).

<sup>7</sup> See Joe Palazzolo, *Judge Tosses Lawsuit Against Law School over Employment Stats*, WSJ LAW BLOG (Mar. 21, 2012, 3:12 PM), <http://blogs.wsj.com/law/2012/03/21/judge-tosses-lawsuit-against-law-school-over-employment-stats/>. While two of these suits have been dismissed, both courts not only accepted the premise that the law school defendants were not delivering strong employment prospects to their students, but also believed this premise to be so obvious that they held it unreasonable for the plaintiffs to have relied on statistics to the contrary. See *MacDonald v. Thomas M. Cooley Law Sch.*, No. 1:11-CV-831, 2012 U.S. Dist. LEXIS 100785, at \*31 (W.D. Mich. July 20, 2012); *Gomez-Jimenez v. N.Y. Law Sch.*, 943 N.Y.S.2d 834, 844–47 (Sup. Ct. 2012). Though the courts emphasized the low rankings of the law school defendants, prospects for many law students appear grim as under two-thirds of all class of 2011 law school graduates obtained a job for which passage of the bar was even required and under half obtained a job in private practice. Press Release, Nat’l Ass’n for Law Placement, *Law School Grads Face Worst Job Market Yet — Less than Half Find Jobs in Private Practice 1–2* (June 7, 2012), available at <http://www.nalp.org/uploads/PressReleases/Classof2011ERSSelectedFindingsPressRelease.pdf>.

<sup>8</sup> See COLL. BD., *TRENDS IN STUDENT AID 2011*, at 10 tbl.1 (2011).

<sup>9</sup> See 11 U.S.C. § 523(a)(8) (2006).

<sup>10</sup> HARKIN REPORT, *supra* note 5, at 131.

and tuitions are set in response to loan supply<sup>11</sup>) and certain law schools (where the majority of graduates cannot find full-time, long-term legal jobs<sup>12</sup> and “[t]he single biggest factor in the ability . . . to raise . . . prices is the availability of government loans”<sup>13</sup>). Finally, returns to higher education will rise because of not only cost reduction at the preceding schools but also value enhancement that results from penalizing institutions that offer poor repayment prospects and directing students at all schools toward courses of study where returns are likely to be the highest.<sup>14</sup>

Notwithstanding the above benefits, the first proposal is insufficient, for while it will reduce the issuance of loans likely to prove problematic, it will not alleviate the impact of issued loans that have already become burdensome. To address the latter problem as it applies to future loans and more significantly, the existing stock of nearly \$1 trillion in outstanding student debt,<sup>15</sup> this Note urges the government to repeal § 523(a)(8). In thus providing student loan debtors with the “fresh start” that underlies the U.S. consumer bankruptcy system,<sup>16</sup> the government will ease a pervasive, punitive, and poorly justified burden. The burden of nondischargeable student loans is pervasive as hundreds of thousands of debtors per year obtain no relief from billions of dollars of educational debt.<sup>17</sup> And the burden can prove punitive because student loan borrowers face significant penalties once they default,<sup>18</sup> as many, particularly those declaring bankruptcy, increasingly do. Yet, while the burden has grown with rising indebtedness and defaults, the rationales for it remain unfounded. Further, the undue hardship exception does not save § 523(a)(8) because few debtors even attempt to make use of it.<sup>19</sup>

If the case for repeal of § 523(a)(8) is therefore strong, it appears even stronger alongside the envisioned risk-rating framework, which might help offset the losses that the government will incur from repeal.

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<sup>11</sup> See Stephanie Riegg Cellini & Claudia Goldin, *Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges* 24 (Nat'l Bureau of Econ. Research, Working Paper No. 17827, 2012).

<sup>12</sup> See Joe Palazzolo, *Law Grads Face Brutal Job Market*, WALL ST. J., June 25, 2012, at A1.

<sup>13</sup> Karen Sloan, *Tuition Is Still Growing*, NAT'L L.J., Aug. 20, 2012, at 4.

<sup>14</sup> See Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. (forthcoming 2013) (manuscript at 56–58), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1941070](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1941070).

<sup>15</sup> See FED. RESERVE BANK OF N.Y., QUARTERLY REPORT ON HOUSEHOLD DEBT AND CREDIT: AUGUST 2012, at 1 (2012).

<sup>16</sup> See, e.g., Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1393 (1985).

<sup>17</sup> See *infra* pp. 604–05.

<sup>18</sup> See STUDENT LOANS OVERVIEW, *supra* note 2, at R-31.

<sup>19</sup> See, e.g., Ron Lieber, *Last Plea on School Loans: Proving a Hopeless Future*, N.Y. TIMES, Sept. 1, 2012, at A1.

Yet the chief purpose of the risk-rating reform is not protecting the government as a lender, but rather discouraging potential borrowers from taking on burdensome loans for increasingly expensive educations that deliver little value.

Before further explaining how such protection can be provided, this Note will, in Part II, offer an overview of the history and current state of both the student loan market and the treatment of student loans in bankruptcy. In Part III, it will describe each proposal, discuss each proposal's beneficial effects, and respond to criticism. The Note will then briefly conclude in Part IV.

## II. THE HISTORY AND CURRENT STATE OF STUDENT LOANS AND THEIR TREATMENT IN BANKRUPTCY

To provide background for the proposals to be introduced in Part III, this Part begins with an overview of the student loan market and then turns to the treatment of student loans in bankruptcy.

### A. *The Student Loan Market*

Accounting for approximately 48% of aid used to finance higher education expenses in 2010–11, student loans are the lifeblood of higher education financing.<sup>20</sup> Because federal and private financing are the two most significant sources of student lending,<sup>21</sup> each is considered in the discussion that follows.

Of the two, federal lending is now far more consequential. In fact, federally supported financing constituted about 93% of all student lending in 2010–11<sup>22</sup> and, through guaranteed and direct loans, accounted for about 86% of the roughly \$1 trillion in student loans outstanding as of June 2012.<sup>23</sup> Not surprisingly, therefore, both of this Note's suggested reforms directly implicate federal student loans.

While private student loans occupy a far smaller share of the student loan market, they too are relevant to the reforms. First, because private student lenders already engage in risk-based pricing,<sup>24</sup> they provide a baseline for the methodology that the government might use. Second, since § 523(a)(8) now applies to all educational loans, the suggested repeal of this provision also implicates private student loans. Indeed, the case for repealing the provision for private student loans is particularly strong as their grounds for nondischargeability are more

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<sup>20</sup> See COLL. BD., *supra* note 8, at 10 tbl.1.

<sup>21</sup> See *id.*

<sup>22</sup> See *id.*

<sup>23</sup> See STUDENT LOANS OVERVIEW, *supra* note 2, at R-20 to -21; FED. RESERVE BANK OF N.Y., *supra* note 15, at 1.

<sup>24</sup> See, e.g., CONSUMER FIN. PROT. BUREAU, PRIVATE STUDENT LOANS 12 (2012), available at [http://files.consumerfinance.gov/f/201207\\_cfpb\\_Reports\\_Private-Student-Loans.pdf](http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf).

tenuous<sup>25</sup> and their terms are generally more burdensome than those of federal student loans.<sup>26</sup>

1. *History.* — Before such terms are discussed, a brief overview of the history of the student loan market is in order.

(a) *Federal Student Loans.* — The origins of federal student lending for higher education can be traced to the National Defense Education Act of 1958,<sup>27</sup> through which the government authorized loans to students in institutions of higher education “[t]o strengthen the national defense and to encourage and assist in the expansion and improvement of educational programs to meet critical national needs.”<sup>28</sup> This was followed by the Higher Education Act of 1965<sup>29</sup> (HEA), which sought to “extend the benefits of college education to more students.”<sup>30</sup> To do so, the HEA established the precursor to the Federal Family Education Loan (FFEL) Program, whereby the federal government guaranteed student loans made by states and private institutions.<sup>31</sup>

In 1993, the government provided another avenue of federal support, amending the HEA to create the Federal Direct Student Loan (FDSL) Program.<sup>32</sup> Under the FDSL Program, the government sought to make loans directly to students with a view toward phasing out the FFEL Program.<sup>33</sup> However, in 1998, Congress eliminated the planned phaseout,<sup>34</sup> and FFEL Program loans accounted for the majority of federally supported loans each year from 2000 to 2010.<sup>35</sup> But the Health Care and Education Reconciliation Act of 2010<sup>36</sup> terminated the FFEL Program after June 30, 2010, leaving only the FDSL Program in place.<sup>37</sup>

As the preceding legislative changes reshaped the federal student lending program, federally supported lending mushroomed. Specifically, from 1990 to 2010, direct and guaranteed federal lending grew at an

<sup>25</sup> See *infra* pp. 596–97.

<sup>26</sup> See CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 89.

<sup>27</sup> Pub. L. No. 85-864, 72 Stat. 1580.

<sup>28</sup> *Id.* pmb., 72 Stat. at 1580; see also *id.* § 201, 72 Stat. at 1583.

<sup>29</sup> Pub. L. No. 89-329, 79 Stat. 1219.

<sup>30</sup> 111 CONG. REC. 22,662 (1965) (statement of Sen. Randolph).

<sup>31</sup> Higher Education Act of 1965 § 421, 79 Stat. at 1236. The program was designated the FFEL Program by the Higher Education Amendments of 1992. See Higher Education Amendments of 1992, Pub. L. No. 102-325, § 411, 106 Stat. 448, 510.

<sup>32</sup> Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 4021, 107 Stat. 312, 341–54.

<sup>33</sup> See *id.*

<sup>34</sup> See Higher Education Amendments of 1998, Pub. L. No. 105-244, § 411, 112 Stat. 1581, 1673.

<sup>35</sup> See COLL. BD., *supra* note 8, at 10 tbl.1.

<sup>36</sup> Pub. L. No. 111-152, 124 Stat. 1029.

<sup>37</sup> See *id.* § 2201, 124 Stat. at 1074–78.

inflation-adjusted annualized rate of about 12% overall<sup>38</sup> and about 6% on a per-student basis.<sup>39</sup> Consequently, in real terms, students were on average borrowing about three times more per year from the federal government in 2010 than in 1990.<sup>40</sup>

This increased borrowing came amid two developments that amplified the average student's funding needs. First, tuitions rose across the board from 1990 to 2010 — though rising grants, tax credits, and tax deductions partially mitigated the effect of surging sticker prices at nonprofit institutions,<sup>41</sup> students could not fully avoid the impact of published tuition and fee increases that outpaced inflation by between 2.8% and 4.5% per year at nonprofit colleges<sup>42</sup> and between 3.3% and 6.8% per year at law schools.<sup>43</sup> Second, as tuitions rose in absolute terms, students chose relatively more expensive higher education options. In particular, the share of students at for-profit colleges more than doubled from 2001 to 2010 as enrollment at these institutions more than tripled.<sup>44</sup> Notably, these schools charge over three and a half times more than comparable public institutions in the same state,<sup>45</sup> and net of grants, can prove even more expensive than private nonprofit institutions with higher published prices as students at such nonprofit schools, particularly low-income individuals, receive far more in grants than comparable students at for-profit institutions.<sup>46</sup> That low-income students often end up paying much less at nonprofit institutions is especially significant because for-profit schools target such students.<sup>47</sup> Indeed, in light of the high net tuitions and high share of low-income individuals at for-profit schools, students attending for-profit institutions borrow in greater numbers and in greater amounts than their counterparts at nonprofit schools.<sup>48</sup> With for-profit students borrowing so much more in such greater percentages amid

<sup>38</sup> See COLL. BD., TRENDS IN STUDENT AID 2011: LIST OF FIGURES AND TABLES tbl.2 (2011) (on file with the Harvard Law School Library).

<sup>39</sup> See *id.* at tbls.3, 3A & 3B.

<sup>40</sup> See *id.* at tbl.3; see also *supra* p. 587 (reporting cumulative, as opposed to annual, average borrowing).

<sup>41</sup> See COLL. BD., TRENDS IN COLLEGE PRICING 2011, at 15 (2011).

<sup>42</sup> See COLL. BD., TRENDS IN COLLEGE PRICING 2011: LIST OF FIGURES AND TABLES tbl.4 (2011) (on file with the Harvard Law School Library).

<sup>43</sup> See AM. BAR ASS'N, LAW SCHOOL TUITION 1985–2011 (2012), available at [http://www.americanbar.org/content/dam/aba/administrative/legal\\_education\\_and\\_admissions\\_to\\_the\\_bar/statistics/ls\\_tuition.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/administrative/legal_education_and_admissions_to_the_bar/statistics/ls_tuition.authcheckdam.pdf). Adjustments for the effect of inflation on law school prices were made with the same consumer price index used by the College Board to adjust college tuition and fees. See COLL. BD., *supra* note 42, at tbl.A2.

<sup>44</sup> See HARKIN REPORT, *supra* note 5, at 37; COLL. BD., *supra* note 38, at tbl.3A.

<sup>45</sup> See HARKIN REPORT, *supra* note 5, at 40.

<sup>46</sup> See COLL. BD., *supra* note 42, at fig.9c.

<sup>47</sup> See HARKIN REPORT, *supra* note 5, at 22.

<sup>48</sup> See *id.*

rapid enrollment growth, the share of federal dollars flowing into for-profit schools more than doubled from 2000 to 2009, rising to about 25% of total federal student aid.<sup>49</sup>

(b) *Private Student Loans.* — While higher education price trends provide important context for, and in some cases explain, federal student lending patterns, private student lending, which “came into existence as an adjunct to the federal student loan program,”<sup>50</sup> has been more heavily influenced by developments in the broader credit market. Specifically, from 2000 to 2007, as the booming securitization market enabled financial institutions to fund loans by issuing asset-backed securities (ABS), annual private student loan issuance mushroomed from just over \$3 billion to more than \$21 billion and lending standards slackened.<sup>51</sup> But when tremors in securitization markets in the middle of 2007 sapped investor demand for student loan ABS, the trend abruptly reversed — private lenders cut annual student loan origination by over 70% between 2007 and 2010 and sharply tightened their lending standards.<sup>52</sup> Significantly, in focusing more on borrower risk, private lenders retrenched most from for-profit institutions, whose students have proven to be the riskiest borrowers.<sup>53</sup> This suggests that if the federal government focuses more on borrower risk, even in the modified manner advocated in Part III, federal funding of for-profit education is also likely to decline disproportionately.<sup>54</sup>

2. *The Terms of Today’s Student Loans.* — The preceding discussion of developments in the federal and private student loan markets omits any mention of perhaps the largest distinction between the two types of loans — the way in which they are priced. This section explores that distinction.

(a) *Federal Student Loans.* — Unlike private lenders, the federal government does not consider borrower risk when extending student loans. Rather, under 20 U.S.C. § 1087e and related provisions, the government is authorized to make four types of direct loans at specified interest rates.<sup>55</sup> While these interest rates are currently fixed, the

<sup>49</sup> See *id.* at 30.

<sup>50</sup> CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 11.

<sup>51</sup> On the importance of the ABS market and weakening lending standards, see *id.* at 17–18, 21. For issuance statistics (presented in the text in nominal terms), see COLL. BD., *supra* note 38, at tbl.2 (reporting inflation-adjusted issuance statistics); and *id.* at tbl.A2 (reporting inflation conversion factors).

<sup>52</sup> On the reduced demand for ABS and tightening lending standards, see CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 18, 22, 114 n.37. For issuance statistics, see COLL. BD., *supra* note 38, at tbl.2.

<sup>53</sup> See CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 33.

<sup>54</sup> See *infra* p. 601.

<sup>55</sup> For the loan types, see 20 U.S.C. § 1087e(a)(2)(A), (B), (C), (D) (2006). For their interest rates, see Moving Ahead for Progress in the 21st Century Act, Pub. L. No. 112-141, § 100301 (July 6, 2012) (amending 20 U.S.C. § 1087e(b)(7)(D) (2006)); 20 U.S.C. § 1087e(b)(7)(A), (B), (C).

government has historically priced loans at a spread to Treasury bills.<sup>56</sup> But, whether based on a fixed or variable rate, in no case has the rate reflected the borrower's risk — if a borrower is eligible for a loan, he or she will be charged the same rate as any other eligible borrower. Further, for the most part, borrower eligibility is unrelated to risk.

In at least one respect, however, direct loan eligibility does include a feature that one might expect to find in a risk-based lending system. In particular, if an institution has a “cohort default rate”<sup>57</sup> (CDR) greater than a specified threshold for each of the three most recent fiscal years, that institution cannot participate in any federal student lending program.<sup>58</sup> Though this provision originated amid concerns that the for-profit higher education sector was “focused more on harvesting federal student aid dollars than on delivering results to students,”<sup>59</sup> critics emphasize that the measure fails to adequately police the for-profit sector, which has allegedly evaded it by placing students in deferment and forbearance until the three-year CDR measurement period concludes.<sup>60</sup>

(b) *Private Student Loans.* — The terms and rates of private student loans vary to a much greater degree than those of federal student loans,<sup>61</sup> but private student loans generally share a key feature that distinguishes them from their federal counterparts — most are priced in a risk-based manner that takes into account creditworthiness.<sup>62</sup> Private lenders examine creditworthiness both in deciding whether to extend a loan and in setting the terms of the loan once extended. Today only those with very good credit and a cosigner are likely to receive loans,<sup>63</sup> and once approved, highly creditworthy borrowers obtain substantially better terms than those who are less creditworthy.<sup>64</sup>

Along with assessing creditworthiness, lenders also look at CDRs and other institutional criteria in making credit decisions.<sup>65</sup> But the Consumer Financial Protection Bureau (CFPB) has expressed concern about lenders' possible reliance on low CDR thresholds, warning that the use of such thresholds might violate the Equal Credit Opportunity

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<sup>56</sup> See, e.g., 20 U.S.C. § 1087e(b)(1), (4)(A).

<sup>57</sup> The “cohort default rate” is essentially a three-year default rate, defined as the percentage of students “who default before the end of the second fiscal year following the fiscal year in which the students entered repayment.” *Id.* § 1085(m)(1)(A).

<sup>58</sup> See *id.* § 1085(a)(2).

<sup>59</sup> Braucher, *supra* note 5, at 463.

<sup>60</sup> See HARKIN REPORT, *supra* note 5, at 302–03; Braucher, *supra* note 5, at 465.

<sup>61</sup> See CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 12.

<sup>62</sup> See *id.*

<sup>63</sup> See *id.* at 12–13, 21–23.

<sup>64</sup> See *id.* at 12.

<sup>65</sup> See *id.* at 79–80.



Act by disproportionately impacting minorities, who are much more likely to attend high-CDR schools.<sup>66</sup> A similar problem might arise from the risk-based proposal outlined in Part III, but before addressing it, this Note turns to another concern — the treatment of student loans in bankruptcy.

### B. *The Treatment of Student Loans in Bankruptcy*

It is a central tenet of modern U.S. bankruptcy law that “the ‘honest but unfortunate debtor’ has a right to bankruptcy’s ‘fresh start.’”<sup>67</sup> This fundamental principle does not, however, apply to the “honest but unfortunate debtor” who cannot pay his student loans. Rather, per § 523(a)(8), “unless excepting such debt from discharge . . . would impose an undue hardship on the debtor and the debtor’s dependents,” neither a Chapter 7 nor a Chapter 13 discharge frees the debtor from any debt for “an educational . . . loan made, insured, or guaranteed by a governmental unit”<sup>68</sup> or “any other educational loan that is a qualified education loan.”<sup>69</sup> This section explores how this discharge exception made its way into the Bankruptcy Code.

Before 1976, student loans were dischargeable.<sup>70</sup> Yet in the years since — on account of fears that former students would opportunistically seek discharge and impair the solvency of the student lending program<sup>71</sup> — student loans were increasingly singled out for special treatment.

First, in 1976, Congress amended the HEA to allow for the discharge of federally guaranteed or insured student loans only after the five-year period following the commencement of repayment unless repayment earlier would cause undue hardship.<sup>72</sup> But this amendment was not intended to be the last word as Congress planned to review a study on the discharge of student loans to be conducted by the General Accounting Office (GAO) and was in the process of overhauling the federal bankruptcy laws.<sup>73</sup>

Indeed, informed partly by the GAO study, debates over what would become the Bankruptcy Code reveal a sharp divide on the wis-

<sup>66</sup> See *id.* at 79–85.

<sup>67</sup> Douglas G. Baird, Symposium, *Discharge, Waiver, and the Behavioral Undercurrents of Debtor-Creditor Law*, 73 U. CHI. L. REV. 17, 17 (2006) (quoting in part *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934)).

<sup>68</sup> 11 U.S.C. § 523(a)(8)(A)(i) (2006).

<sup>69</sup> *Id.* § 523(a)(8)(B).

<sup>70</sup> See 11 U.S.C. § 35(a) (1976) (repealed by Bankruptcy Reform Act of 1978, Pub. L. No. 95-598); see also Rafael I. Pardo & Michelle R. Lacey, *Undue Hardship in the Bankruptcy Courts: An Empirical Assessment of the Discharge of Educational Debt*, 74 U. CIN. L. REV. 405, 419 (2005).

<sup>71</sup> See *infra* section III.B.3(a).

<sup>72</sup> Education Amendments of 1976, Pub. L. No. 94-482, § 127(a), 90 Stat. 2081, 2141.

<sup>73</sup> See Pardo & Lacey, *supra* note 70, at 422.

dom of retaining the HEA amendment. On the one hand, some derided the amendment as “a discriminatory remedy for a ‘scandal’ which exist[ed] primarily in the imagination.”<sup>74</sup> In line with this view, in 1977, the House Judiciary Committee’s proposed bankruptcy legislation would have repealed the amendment.<sup>75</sup> On the other hand, Representative Allen Ertel stressed that federal student loan defaults had markedly increased and that such a trend would result in “the destruction of student loan programs.”<sup>76</sup>

Accordingly, when in 1978 the House considered what would become the Bankruptcy Code, Representative Ertel added an amendment that essentially preserved the 1976 provision.<sup>77</sup> The amendment offered by Representative Ertel prevailed in both the House<sup>78</sup> and — apparently without debate — the Senate.<sup>79</sup> Thus, the Bankruptcy Reform Act of 1978<sup>80</sup> included much of the substance of the Ertel provision and largely preserved the 1976 HEA amendment.<sup>81</sup>

After introducing the dischargeability exception into the Bankruptcy Code, Congress spent the next three decades strengthening it by broadening the class of creditors to which it applied and narrowing the terms under which debtors could escape it.<sup>82</sup>

Accomplishing the former result were amendments that extended protection (i) in 1979 to educational loans “made, insured, or guaranteed by a governmental unit, or made under any program funded . . . by a governmental unit or a nonprofit institution of higher education”;<sup>83</sup> (ii) in 1984 to educational loans made under programs financed by any nonprofit institution;<sup>84</sup> (iii) in 1990 to educational benefit overpayments;<sup>85</sup> and (iv) in 2005 to all qualified educational loans, including those made by for-profit private lenders.<sup>86</sup> This last extension, enacted under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005<sup>87</sup> (BAPCPA), is particularly noteworthy because it is unrelated to a key

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<sup>74</sup> H.R. REP. NO. 95-595, at 148 (1977).

<sup>75</sup> See Pardo & Lacey, *supra* note 70, at 423.

<sup>76</sup> H.R. REP. NO. 95-595, at 537.

<sup>77</sup> See 124 CONG. REC. 1791 (1978).

<sup>78</sup> See *id.* at 1798.

<sup>79</sup> See Pardo & Lacey, *supra* note 70, at 425.

<sup>80</sup> Pub. L. No. 95-598, 92 Stat. 2549.

<sup>81</sup> See *id.* § 523(a)(8), 92 Stat. at 2591.

<sup>82</sup> See Pardo & Lacey, *supra* note 70, at 427.

<sup>83</sup> Act of Aug. 14, 1979, Pub. L. No. 96-56, § 3(1), 93 Stat. 387, 387.

<sup>84</sup> See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 454(a)(2), 98 Stat. 333, 376.

<sup>85</sup> See Crime Control Act of 1990, Pub. L. No. 101-647, § 3621(1), 104 Stat. 4789, 4964-65.

<sup>86</sup> See Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 220, 119 Stat. 23, 59.

<sup>87</sup> *Id.*

rationale for the exception (protecting the public fisc),<sup>88</sup> represents a massive expansion of the exception, and despite its significance, was passed without any objections from lawmakers.<sup>89</sup>

While expanding the class of creditors covered by the exception, Congress has narrowed the means by which debtors can avoid it. In 1990, it increased the five-year period of nondischargeability to seven years<sup>90</sup> and extended nondischargeability to Chapter 13 proceedings.<sup>91</sup> Further, in 1998, it eliminated reference to waiting periods of nondischargeability altogether and thereby made a showing of undue hardship the only means of discharge.<sup>92</sup>

All of these changes have come despite calls to limit the exception. In 1997, the National Bankruptcy Review Commission, which was statutorily required to prepare a report of recommendations on the Bankruptcy Code,<sup>93</sup> advised that the dischargeability exception be repealed.<sup>94</sup> The Commission emphasized that there was no evidence that the bankruptcy system had been abused when student loans were more easily dischargeable,<sup>95</sup> there was not a clear link between dischargeability and default,<sup>96</sup> and the undue hardship exception was narrowly construed in practice and thus applied in a manner potentially counter to legislative intent.<sup>97</sup>

More recently, there have been legislative efforts to roll back the dischargeability exception for privately issued student loans, with Representative Steve Cohen's proposal of the Private Student Loan Bankruptcy Fairness Act of 2010<sup>98</sup> and Senator Richard Durbin's introduction of a similar act in the Senate.<sup>99</sup> Explaining the rationale for his proposed repeal, Representative Cohen stressed that the 2005 extension to private loans was passed "without any substantive discussion

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<sup>88</sup> See John A.E. Pottow, *The Nondischargeability of Student Loans in Personal Bankruptcy Proceedings: The Search for a Theory*, 44 CANADIAN BUS. L.J. 245, 250 n.22 (2007).

<sup>89</sup> See Rafael I. Pardo & Michelle R. Lacey, *The Real Student-Loan Scandal: Undue Hardship Discharge Litigation*, 83 AM. BANKR. L.J. 179, 181 (2009).

<sup>90</sup> See Crime Control Act of 1990 § 3621(2), 104 Stat. at 4965.

<sup>91</sup> See Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 3007(b)(1), 104 Stat. 1388, 1388-28. This provision was made permanent by a subsequent amendment. See Higher Education Amendments of 1992, Pub. L. No. 102-325, § 1558, 106 Stat. 448, 841.

<sup>92</sup> See Higher Education Amendments of 1998, Pub. L. No. 105-244, § 971(a), 112 Stat. 1581, 1837.

<sup>93</sup> See National Bankruptcy Review Commission Act, Pub. L. No. 103-394, tit. VI, § 603, 108 Stat. 4106, 4147 (1994).

<sup>94</sup> See NAT'L BANKR. REVIEW COMM'N, *BANKRUPTCY: THE NEXT TWENTY YEARS* 207 (1997).

<sup>95</sup> See *id.* at 213.

<sup>96</sup> See *id.* at 213, 215.

<sup>97</sup> See *id.* at 211.

<sup>98</sup> See Private Student Loan Bankruptcy Fairness Act of 2010, H.R. 5043, 111th Cong. § 2.

<sup>99</sup> See Fairness for Struggling Students Act of 2010, S. 3219, 111th Cong. § 2.

or empirical evidence,<sup>100</sup> such loans were no cheaper after the exception than before, and they lacked many of the consumer protections of federal loans.<sup>101</sup> Nonetheless, both Representative Cohen's and Senator Durbin's bills died,<sup>102</sup> and their repropoed versions are unlikely to gain traction.<sup>103</sup>

But calls for reform have not abated. Indeed, the CFPB brought renewed attention to private student loan dischargeability in its July 2012 report on the private student loan market, suggesting that it might be "prudent to consider modifying the code in light of the impact on young borrowers in challenging labor market conditions."<sup>104</sup>

### III. FIXING HIGHER EDUCATION ECONOMICS

This Part goes one step further than the CFPB and calls for a repeal of not just the private student loan dischargeability exception but § 523(a)(8) altogether. Additionally, this Part proposes that the federal government introduce a risk-based pricing framework for its student loans. These two suggested reforms are economically connected insofar as risk-based pricing might restore some of the creditor protection that the government will lose by allowing full dischargeability. But risk-based pricing is not required to render repeal of § 523(a)(8) financially feasible for the government. Thus, though the proposals are complementary, they are independently viable and for this reason, presented as separate solutions to the problems of higher education economics.

#### A. Risk-Rating Loans

A carefully designed risk-based pricing framework can mitigate each of the four problems of higher education economics — increasing tuitions, rising indebtedness, mounting defaults, and declining returns — largely by saving potential borrowers from themselves. As paternalistic as this notion might seem, it is grounded in the market-based observation that by not providing a reliable signal of the risk-

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<sup>100</sup> *Private Student Loan Bankruptcy Fairness Act of 2010: Hearing on H.R. 5043 Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 1–2 (2010) (statement of Rep. Cohen, Chairman, Subcomm. on Commercial & Admin. Law).

<sup>101</sup> *See id.*

<sup>102</sup> *See H.R. 5043 (111th): Private Student Loan Bankruptcy Fairness Act of 2010*, GOVTRACK, <http://www.govtrack.us/congress/bills/111/hr5043> (last visited Oct. 27, 2012); *S. 3219 (111th): Fairness for Struggling Students Act of 2010*, GOVTRACK, <http://www.govtrack.us/congress/bills/111/s3219> (last visited Oct. 27, 2012).

<sup>103</sup> *See H.R. 2028: Private Student Loan Bankruptcy Fairness Act of 2011*, GOVTRACK, <http://www.govtrack.us/congress/bills/112/hr2028> (last visited Oct. 27, 2012); *S. 1102: Fairness for Struggling Students Act of 2011*, GOVTRACK, <http://www.govtrack.us/congress/bills/112/s1102> (last visited Oct. 27, 2012).

<sup>104</sup> CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 87.

ness of the debt that certain borrowers are assuming, the federal government is leading them to take on too much of it for too little educational value. This section therefore urges the government to employ a pricing system that clearly differentiates loan risk without unduly denying educational access.

1. *The Proposal.* — The practices of private student lenders outlined in section II.A.2(b) provide a useful baseline for the envisioned system. Unlike the private methodology, however, the government risk-rating framework must balance the objective of capturing factors relevant to repayment ability with the federal student lending program's primary goal of promoting access to education among the needy.<sup>105</sup> Accordingly, even though measures like parental education levels, family income, and other indicia of current creditworthiness are predictive of default,<sup>106</sup> the government should ignore these factors, especially with respect to undergraduate lending,<sup>107</sup> because they will limit access and are often beyond the borrower's control.<sup>108</sup>

Generally precluded by policy considerations from examining indicia of current creditworthiness, the government should instead look to post-graduation employment prospects.<sup>109</sup> These prospects can be modeled in terms of (i) the quality of the institution attended and (ii) the course of study pursued at that institution.

As to the first of these two factors, the government should rely on an improved CDR measure.<sup>110</sup> On the one hand, both the use and calculation of CDRs should be modified so as not to unduly restrict lending. Regarding CDR use, whereas the government and certain private lenders now employ CDRs to directly limit loan access, the government should instead use CDRs to set loan rates and, to avoid inappropriate denials of access, should explicitly restrict access only at sufficiently high CDRs (which might exceed current thresholds). Regarding CDR calculation, the government must control for student characteristics because for-profit institutions, which have the highest CDRs, are disproportionately attended by poor, nontraditional students, who have above-average default rates.<sup>111</sup> Thus, while some for-profit institutions likely do offer

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<sup>105</sup> See, e.g., STUDENT LOANS OVERVIEW, *supra* note 2, at R-3.

<sup>106</sup> See Simkovic, *supra* note 14, at 54.

<sup>107</sup> One might argue that for graduate lending, the government should look at current creditworthiness both because graduate students tend to have more control over current creditworthiness than do undergraduate borrowers (for whom the determination is more likely to be based on family finances) and because the case for promoting graduate education among the needy is perhaps weaker than the case for promoting undergraduate education.

<sup>108</sup> See Simkovic, *supra* note 14, at 55–56.

<sup>109</sup> See *id.* at 53.

<sup>110</sup> On the government's current use of CDRs, see *supra* p. 594.

<sup>111</sup> See Simkovic, *supra* note 14, at 54–55; see also ASS'N OF PRIVATE SECTOR COLLS. AND UNIVS., COHORT DEFAULT RATES IN CONTEXT 6–9 (2011), available at <http://www.apscu.org>

low-quality educations,<sup>112</sup> failing to adjust for student characteristics in calculating CDRs will exaggerate these schools' quality deficiencies.

On the other hand, CDRs should be strengthened to stifle inappropriate lending. As explained in section II.A.2(a), some for-profit institutions might be understating their true CDRs by placing students into deferment or forbearance until the prescribed CDR measurement period ends.<sup>113</sup> To guard against such manipulation, the government should extend the CDR measurement window to a period long enough to make bad faith deferment or forbearance uneconomical.

As to the second of the two factors behind post-graduation employment prospects, "[t]he data suggests that there are certain majors that are much lower risk than others as measured by post-graduation wages and debt to income ratios."<sup>114</sup> The government should therefore offer preferential interest rates to students pursuing such majors. Analogously, at the professional school level, the government should set interest rates based on the post-graduation wages of the profession in question.

2. *The Proposal's Beneficial Effects.* — In pursuing the preceding policies, the government will likely reduce defaults, decrease educational costs and thus indebtedness, and increase educational returns. It will thereby mitigate all of the problems of higher education economics identified in the Introduction.

Defaults will decline as higher interest rates accompanying the loans most likely to become unmanageable dissuade some individuals from assuming these loans in the first place. While higher interest rates also might make default more likely for the individuals who nonetheless assume such debt, this effect is likely to be outweighed by the prior effect of decreased loan demand.

Educational costs will decline among the subset of schools that (i) set tuition in response to loan availability and (ii) will be confronted with reduced loan availability owing to the poor repayment prospects of their graduates. Regarding the first of these two conditions, while the effect of loan supply on tuition at nonprofit colleges is mixed,<sup>115</sup> for-profit institutions and law schools do appear price responsive to loan availability. As to for-profit schools, recent research suggests that such institutions "raise tuition to capture the maximum grant aid available."<sup>116</sup> This finding is not surprising because, as for-profit enti-

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<sup>112</sup> See HARKIN REPORT, *supra* note 5, at 18.

<sup>113</sup> See *supra* p. 594.

<sup>114</sup> Simkovic, *supra* note 14, at 56.

<sup>115</sup> See Cellini & Goldin, *supra* note 11, at 7; Simkovic, *supra* note 14, at 59 n.228.

<sup>116</sup> Cellini & Goldin, *supra* note 11, at 24.

ties, these institutions have an incentive — and indeed, an obligation to stakeholders — to extract as much profit from students as they can.<sup>117</sup>

In contrast, law schools, for which “[d]irect federal loans have [also] become the lifeblood,”<sup>118</sup> are generally nonprofit enterprises. These schools have nonetheless adopted a market-based mentality similar to that of for-profit schools, pushing forward price increases because students have been willing and able to pay for them with loans.<sup>119</sup> Two factors might explain why. First, law schools might be answerable to the economic needs of parent universities, which have been known to require a large share of law school revenue to subsidize less profitable areas.<sup>120</sup> Second, law schools are rewarded by the influential *U.S. News & World Report* rankings for increasing spending per student — a result that can be achieved by raising prices and directing the increased revenue to any educational expenditure, regardless of its didactic benefit.<sup>121</sup>

Not only, as the preceding discussion suggests, might law schools and for-profit institutions be the most price responsive to diminished loan supply, but some of these institutions might also face the largest reductions in loans under this section’s proposal. That is, the cost of loans to attend certain for-profit institutions and law schools will sharply rise given the repayment problems of these schools’ graduates.<sup>122</sup> And, confronted with rising costs to attend such schools, students will supply these schools with less loan money, leading to tuition reductions. Tuition reductions driven purely by reduced loan availability will in turn decrease indebtedness and increase educational returns.

Educational returns will increase not just through the tuition reductions likely to take place at the subset of institutions identified above but also through the enhancement of educational value likely to occur at a wider swath of schools. Regarding such enhancement, this proposal recognizes that diminishing returns to higher education stem from both the failure of institutions to adequately prepare students and the failure of students to select courses of study that will make them competitive in the job market.<sup>123</sup> The proposal addresses each failure, targeting the first by penalizing institutions with unduly high CDRs

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<sup>117</sup> See HARKIN REPORT, *supra* note 5, at 42.

<sup>118</sup> William D. Henderson & Rachel M. Zahorsky, *The Law School Bubble*, A.B.A. J., Jan. 2012, at 30, 32.

<sup>119</sup> See BRIAN Z. TAMANAHA, *FAILING LAW SCHOOLS* 132 (2012).

<sup>120</sup> See Segal, *supra* note 1.

<sup>121</sup> See *id.*

<sup>122</sup> See, e.g., *supra* pp. 588–89; cf. Palazzolo, *supra* note 12.

<sup>123</sup> See Shilling, *supra* note 4.

and targeting the second by offering students interest rate incentives to pursue higher-value areas of study.

3. *Criticism.* — The chief criticism of this proposal is that it could unfairly restrict loan access and thereby defeat the purpose of the federal student loan program. The proposal attempts to address this concern by advocating that the government depart from the practices of private lenders in two ways: first, by not taking current creditworthiness into account in setting loan rates and second, by avoiding explicit restrictions on loan access except at sufficiently high CDRs. To be sure, setting high interest rates will — and is intended to — indirectly limit loan access, and even with modified CDRs, poorer, nontraditional students who attend low-quality schools might face the greatest access limitations. Critics might further argue that by raising interest rates for loans to attend certain poorly performing institutions, the proposal will cut off the only access to higher education that some individuals have. But this would not be a suboptimal outcome given that facilitating access to education is a counterproductive objective if the education ends up producing more harm, in the form of unmanageable debts, than good.<sup>124</sup> Furthermore, it might not be a likely outcome owing to the abundance of inexpensive for-profit schools that are ineligible for federal student loans in the first place. If, as recent research suggests, “students who lose eligibility for . . . student loans . . . may still be able to afford training in a less expensive for-profit institution that is not Title IV eligible,”<sup>125</sup> a proposal with the effect of reducing loan eligibility might simply funnel more students into less expensive for-profit schools.

Even if this beneficial result does not materialize, the outcome of limiting access to poorly performing institutions that might be disproportionately attended by minority, poor, or nontraditional students should be distinguished from the CFPB’s fear discussed in section II.A.2(b).<sup>126</sup> In expressing concern that actions of private student lenders were producing disproportionately negative effects on minorities, the CFPB worried that lenders were taking institutional quality into account unreasonably.<sup>127</sup> This worry can be allayed in the proposed framework by ensuring that interest rates stay reasonable at relatively low CDRs and escalate to substantial levels only at very high CDRs.

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<sup>124</sup> See Braucher, *supra* note 5, at 445–46, 448. Surely, the recommended repeal of § 523(a)(8) can allay some of the harm from unmanageable debts, but repeal will not help the many defaulting borrowers who do not declare bankruptcy.

<sup>125</sup> Cellini & Goldin, *supra* note 11, at 25.

<sup>126</sup> See *supra* pp. 594–95.

<sup>127</sup> See CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 84.



An entirely different worry is that even if the proposal does not unduly limit educational access, loan pricing based on course of study will unfairly restrict the types of education to which certain borrowers have access, likely steering the poor away from the humanities.<sup>128</sup> But such a result is not inconsistent with the history and purpose of the federal student loan program, which began as an effort to encourage science education<sup>129</sup> and has always treated education on partly economic terms, as an “investment.”<sup>130</sup> Indeed, to the extent that the government continues to issue educational loans that must be repaid, lenders and borrowers will benefit from a system encouraging students to engage in pursuits offering the best chances of repayment.

*B. Repealing § 523(a)(8)*

Whereas the preceding proposal is aimed at reducing indebtedness and defaults by dissuading potential borrowers from assuming unmanageable student loans, the proposal outlined in this section aims to decrease indebtedness and defaults by relieving certain borrowers of unmanageable student loans that have already been assumed. This section’s suggested reform, the repeal of § 523(a)(8), accomplishes this end through targeting the most overlooked, yet most distressed borrowers — those whose financial condition is dire enough to have led to bankruptcy.

These individuals have been overlooked as the government has instead focused on relief for federal student loan borrowers outside of bankruptcy in the form of income-based repayment plans that cap monthly payments at a specified percentage of discretionary income and forgive the unpaid balance after a specified number of years.<sup>131</sup> Yet, while the latest income-based repayment plan is expected to lower loan payments for 1.6 million borrowers, it does not apply to the most problematic classes of student debt — private loans, loans in default, and the large stock of loans made before the plan’s effective date — or offer much solace to the most hard-pressed class of borrowers.<sup>132</sup>

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<sup>128</sup> Cf. Simkovic, *supra* note 14, at 63.

<sup>129</sup> See *supra* p. 591; see also National Defense Education Act of 1958, Pub. L. No. 85-864, § 101, 72 Stat. 1580, 1581.

<sup>130</sup> See Simkovic, *supra* note 14, at 65.

<sup>131</sup> See Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 2213, 124 Stat. 1029, 1081 (codified as amended in scattered sections of 20, 26, and 42 U.S.C.); College Cost Reduction and Access Act, Pub. L. No. 110-84, § 203, 121 Stat. 784, 792–95 (2007) (codified as amended in scattered sections of 20 U.S.C.). President Obama hastened the implementation of the Health Care and Education Reconciliation Act of 2010’s income-based repayment plan through an executive action. See Megan Slack, *Income Based Repayment: Everything You Need to Know*, WHITE HOUSE BLOG (June 7, 2012, 10:59 AM), <http://www.whitehouse.gov/blog/2012/06/07/income-based-repayment-everything-you-need-know>.

<sup>132</sup> See Slack, *supra* note 131.

The suggested repeal of § 523(a)(8), however, makes up for these shortcomings. In allowing borrowers who have declared bankruptcy to discharge all of their student loans whenever incurred, this proposal recognizes that student loans pervade consumer bankruptcies and that, absent discharge of these obligations, debtors have little hope of ever getting out from under them and realizing the benefits of bankruptcy's fresh start. Indeed, the increasing weight of these obligations threatens to crush not only those in bankruptcy but also society as a whole.

1. *The Proposal.* — To most effectively remove this weight, the envisioned repeal of § 523(a)(8) should apply (i) to all student loans (ii) issued at all times. The first recommendation means that repeal should cover private and federal student loans. The second indicates that repeal should apply to loans issued not only after the change is passed but also before. While this type of retroactivity may seem unfair to creditors, amendments to the Bankruptcy Code often operate in this fashion.<sup>133</sup> Convention aside, such retroactivity will maximize the impact of repeal without imposing unmanageable costs on the government.

2. *The Proposal's Beneficial Effects.* — By allowing student loans to be discharged more easily, the envisioned repeal of § 523(a)(8) will clearly reduce indebtedness and defaults among the most distressed borrowers. Indebtedness will fall as student loans are wiped away in bankruptcy, and as debt falls, so too will the absolute number of defaults. Further, overall default rates will likely decline as the analysis below suggests that borrowers declaring bankruptcy default at rates far above average.

Few would dispute the preceding conclusions, so the real question is why borrowers declaring bankruptcy warrant such a reprieve. One might argue, as section 3(a) does, that this question is misplaced because § 523(a)(8) should never have been inserted into the Bankruptcy Code in the first place. But setting aside what might be the strongest argument for repeal, one can identify several other reasons for it.

First, the number of student loan borrowers in bankruptcy and the amount of educational debt not discharged are large and likely growing. Before the recession, in 2007, roughly 230,000, or about 29% of, consumers filing for bankruptcy held student loans, which totaled approximately \$4.8 billion and were almost entirely not discharged.<sup>134</sup> Based

<sup>133</sup> That is, though amendments tend to apply only to future bankruptcy cases, they generally extend to contracts in these proceedings that predate the amendments. See, e.g., Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1501(b), 119 Stat. 23, 216 (codified as amended in scattered sections of 11 U.S.C.); Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 553(a), 98 Stat. 333, 392 (codified as amended in scattered sections of 11 and 28 U.S.C.).

<sup>134</sup> The estimated number of consumers holding student loans in bankruptcy is based on (i) the estimated percentage of consumers holding such debt, see Jason Iuliano, *An Empirical Assessment of Student Loan Discharges and the Undue Hardship Standard*, 86 AM. BANKR. L.J. 495, 504

solely on subsequent growth in the number of consumer bankruptcies, one might estimate that in 2011, nearly 390,000 consumer debtors held about \$7.9 billion in aggregate educational debt that was not discharged.<sup>135</sup> If, however, one conservatively assumes that average educational debt in bankruptcy grew 2% annually from 2007 to 2011 (close to the real growth rate in per-student lending from 2006 to 2010 but below the nearly 5% real growth rate from 2000 to 2010<sup>136</sup>), aggregate educational debt not discharged in bankruptcy would stand at about \$8.6 billion. And the number of student loan debtors and aggregate educational debt not discharged in bankruptcy might be even higher if the percentage of consumer debtors holding student loans increased from 2007 to 2011 — a plausible proposition given that student loan debt has risen while other forms of household borrowing have fallen since 2008.<sup>137</sup>

Not only is the plight of student loan debtors therefore large, but it is also quite worrisome. To be sure, student loan borrowers in general do not have it easy. Even before the recent recession, it was said that because of rising student loan indebtedness, “[i]ncreasingly, students must begin their adult lives with debts that outstrip their earning potential, creating a financial vortex from which they may never escape.”<sup>138</sup> This seems especially true now, with average student indebtedness even higher,<sup>139</sup> 54% of bachelor’s degree holders under twenty-five jobless or underemployed,<sup>140</sup> and real wages stagnating for those who can obtain jobs.<sup>141</sup> Moreover, it rings most true for those who declare bankruptcy because their unemployment rate is about double the national average<sup>142</sup> and their mean income is between 10%

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(2012), and (ii) the number of consumer bankruptcies in 2007, see ADMIN. OFFICE OF THE U.S. COURTS, 2007 REPORT OF STATISTICS REQUIRED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005, at 28 tbl.1X (2008). The estimated amount of student loans in bankruptcy is based on (i) the number of consumers holding student loans in bankruptcy and (ii) the average amount they held, see Iuliano, *supra*, at 504–05, 510 fig.3 (calculated from the table as a weighted average of the filers who did and did not seek discharge). On the infinitesimal amount of student debt discharged, see *id.* at 505 fig.1.

<sup>135</sup> For the number of consumer bankruptcies in 2011, see ADMIN. OFFICE OF THE U.S. COURTS, 2011 REPORT OF STATISTICS REQUIRED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005, at 28 tbl.1X (2012) [hereinafter 2011 BAPCPA REPORT].

<sup>136</sup> See COLL. BD., *supra* note 38, at fig.1.

<sup>137</sup> See FED. RESERVE BANK OF N.Y., *supra* note 15, at 1.

<sup>138</sup> Elizabeth Warren et al., *Service Pays: Creating Opportunities by Linking College with Public Service*, 1 HARV. L. & POL’Y REV. 127, 130 (2007).

<sup>139</sup> See *supra* p. 592.

<sup>140</sup> See Shilling, *supra* note 4.

<sup>141</sup> See ANDREW SUM ET AL., THE “JOBLESS AND WAGELESS” RECOVERY FROM THE GREAT RECESSION OF 2007–2009, at 22 (2011).

<sup>142</sup> Compare INST. FOR FIN. LITERACY, 2010 ANNUAL CONSUMER BANKRUPTCY DEMOGRAPHICS REPORT 14 tbl.6 (2011), with *Labor Force Statistics from the Current Popula-*

and 20% lower.<sup>143</sup> Further, according to a study of bankruptcy filings in 2007, student loan debtors have on average close to zero disposable income and a ratio of student loan debt to annual income of nearly 0.7-to-one.<sup>144</sup> These figures appear particularly troubling as these debtors hold a considerable amount of other debt,<sup>145</sup> a meaningful portion of which is also not discharged since it either cannot be or, more significantly, is secured by assets that debtors need, such as cars and homes.<sup>146</sup> Indeed, because the study of 2007 filings indicates that on average, student loan debtors have a total debt-to-income ratio of about five-to-one<sup>147</sup> and because between about 60% and 70% of debt declared in consumer bankruptcies is secured,<sup>148</sup> it is likely that student loan debtors exit bankruptcy just as they entered it — unable to pay their debts.

To make matters worse, the consequences of defaulting on student loans, a risk that the preceding analysis suggests is high, are unusually severe. For one, default puts borrowers beyond the reach of income-based repayment.<sup>149</sup> Additionally, it exposes them to financial penalties<sup>150</sup> and pressure from student loan debt collectors wielding “power that would make a mobster envious,” including the ability to seize tax refunds and Social Security payments.<sup>151</sup> Finally, default or even difficulty making payments has punishing macroeconomic and sociological effects given that “[g]raduates lugging huge debt loads with few job opportunities to pay them off are reluctant to buy cars, purchase homes, or start families.”<sup>152</sup>

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*tion Survey*, BUREAU LAB. STAT., <http://data.bls.gov/timeseries/LNS14000000> (last visited Oct. 27, 2012).

<sup>143</sup> Compare ADMIN. OFFICE OF THE U.S. COURTS, 2010 REPORT OF STATISTICS REQUIRED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005, at 47 tbl.2X (2011) [hereinafter 2010 BAPCPA REPORT], with *National Average Wage Index*, SOC. SECURITY ONLINE, <http://www.ssa.gov/oact/cola/AWI.html> (last visited Oct. 27, 2012).

<sup>144</sup> See Iuliano, *supra* note 134, at 504–05, 510 fig.3 (calculated as a weighted average of the characteristics of the filers who did and did not seek discharge).

<sup>145</sup> See *id.*

<sup>146</sup> See Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 NW. U. L. REV. 1463, 1497 (2005).

<sup>147</sup> See Iuliano, *supra* note 134, at 504–05, 510 fig.3.

<sup>148</sup> See, e.g., 2011 BAPCPA REPORT, *supra* note 135, at 28 tbl.1X; 2010 BAPCPA REPORT, *supra* note 143, at 31 tbl.1X; ADMIN. OFFICE OF THE U.S. COURTS, 2009 REPORT OF STATISTICS REQUIRED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005, at 32 tbl.1X (2010).

<sup>149</sup> See *supra* p. 603.

<sup>150</sup> See STUDENT LOANS OVERVIEW, *supra* note 2, at R-31.

<sup>151</sup> John Hechinger, *U.S. Gets Tough on Failure to Repay Student Loans*, WALL ST. J., Jan. 6, 2005, at A1 (quoting Professor Elizabeth Warren) (internal quotation mark omitted).

<sup>152</sup> See Jonathan R. Laing, *What a Drag!*, BARRON'S, Apr. 16, 2012, at 23, 24.

Admittedly, as a large number of defaulting student loan borrowers do not declare bankruptcy<sup>153</sup> and a change in dischargeability laws is unlikely to affect their willingness to do so,<sup>154</sup> repeal of § 523(a)(8) will not alleviate all of the preceding concerns. But nor does it preclude other government action, such as an extension of income-based repayment to all existing loans or a softening of default penalties and debt collection powers.

3. *Criticism.* — Though the preceding discussion implies that repeal might not go far enough, the chief criticism is likely that it goes too far. Specifically, critics might argue that (i) § 523(a)(8) is justified, (ii) the provision might not be justified, but it works in practice owing to the undue hardship exception, or (iii) regardless of whether the provision is justified, repeal will simply cost too much.

(a) *Justifications for § 523(a)(8).* — One might make a number of arguments in favor of § 523(a)(8), but none are compelling. Indeed, the absence of a strong justification for the provision might be the strongest argument for its repeal.

First, one might claim, as the provision's proponents initially did, that § 523(a)(8) is needed to ensure the viability of the federal student loan program.<sup>155</sup> When first made, this argument was premised on the beliefs that (i) student loan discharges would soon cripple the federal student loan program and (ii) recent negative trends in bankruptcy filings had been caused by the extant dischargeability regime (which lacked a student loan exception).<sup>156</sup> But neither of these beliefs has support. Debunking the first premise is the fact that by 1977, under 0.3% of the value of all federally guaranteed student loans had been discharged in bankruptcy<sup>157</sup> — a rate that was comparable to that for consumer loans more generally<sup>158</sup> and a rate that the government could clearly withstand. Debunking the second premise is the fact that, though bankruptcy losses increased during the period in question,<sup>159</sup> the dischargeability regime could not have accounted for the increase since student loans had always been dischargeable over the period studied. Moreover, based on subsequent studies, the National Bankruptcy Review Commission concluded that “empirical evidence [did] not support the oft-cited allegation that changes in bankruptcy

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<sup>153</sup> Cf. CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 73 tbl.19.

<sup>154</sup> See *infra* pp. 607–08.

<sup>155</sup> See, e.g., 124 CONG. REC. 1791–92 (1978) (statement of Rep. Ertel).

<sup>156</sup> See *id.*

<sup>157</sup> See H.R. REP. NO. 95-595, at 148 (1977).

<sup>158</sup> See *id.* at 150.

<sup>159</sup> See *id.* at 152–53.

law entitlements — exemptions, dischargeability, or otherwise — affect the rate of filing for bankruptcy.”<sup>160</sup>

This finding also undermines another argument initially advanced by the provision’s proponents — namely, that students would opportunistically seek discharge.<sup>161</sup> Not only did the National Bankruptcy Commission find no evidence of opportunism, but fears over such behavior also provide insufficient justification for § 523(a)(8) given that many debts can be opportunistically discharged.<sup>162</sup> And while one might argue that discharge could be a particularly potent weapon for recent university graduates with few assets but significant future income streams,<sup>163</sup> this argument ignores the fact that educational debt accounts for only a fraction of the borrowing of debtors holding student loans,<sup>164</sup> so it is unlikely to exclusively influence their bankruptcy decisions. Additionally, though it might seem inequitable to allow a currently cash-strapped debtor to dodge debt that he might later be able to repay, the Bankruptcy Code generally permits such behavior with respect to other unsecured loans.

Justifications not relied on by legislators are also inadequate. The most compelling of these are economic rationales. The first, which applies only to federally supported loans, is that the dischargeability exception protects the public fisc.<sup>165</sup> But, as discussed above, the exception is not needed to preserve the federal student loan program,<sup>166</sup> and eliminating it would likely not even meaningfully constrain lending under the program, which is profitable enough to withstand losses from discharges.<sup>167</sup> The second economic justification for the dischargeability exception, which applies to private and federally supported student loans, is that it lowers interest rates and thereby increases educational access.<sup>168</sup> Yet there is no evidence that private lenders have reduced interest rates since BAPCPA extended nondischargeability protection to them,<sup>169</sup> and after 2008, access to private student loans has actually *decreased*.<sup>170</sup>

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<sup>160</sup> NAT’L BANKR. REVIEW COMM’N, *supra* note 94, at 213.

<sup>161</sup> See 124 CONG. REC. 1792 (1978) (statement of Rep. Ertel).

<sup>162</sup> See Pottow, *supra* note 88, at 254.

<sup>163</sup> See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 250–51 (1986).

<sup>164</sup> See *supra* p. 606.

<sup>165</sup> See Pottow, *supra* note 88, at 261.

<sup>166</sup> See *supra* pp. 607–08.

<sup>167</sup> See *infra* p. 610.

<sup>168</sup> See Pottow, *supra* note 88, at 261–63.

<sup>169</sup> See *Private Student Loan Bankruptcy Fairness Act of 2010: Hearing on H.R. 5043 Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary*, *supra* note 100, at 2 (statement of Rep. Cohen, Chairman, Subcomm. on Commercial & Admin. Law); CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 73–74.

<sup>170</sup> See *supra* pp. 593–94.

(b) *Undue Hardship*. — One might reject all of the preceding justifications and still support § 523(a)(8) on the grounds that, owing to the undue hardship exception, it ends up excusing those who truly cannot pay. But, though the exception might have been intended to operate in this way,<sup>171</sup> it has fallen well short of this goal.

Most significantly, the number of debtors who cannot reasonably pay their student loans appears to substantially dwarf the number who even attempt to bring undue hardship cases. That is, while section 2 suggests that a considerable share of bankruptcy filers cannot bear the burden of their educational debt,<sup>172</sup> only between 0.1% and 0.3% of student loan debtors actually try to obtain discharge through undue hardship litigation.<sup>173</sup>

To explain this discrepancy, commentators offer varying accounts. On the one hand, the traditional view has stressed that pursuing undue hardship litigation is difficult,<sup>174</sup> expensive,<sup>175</sup> and subject to the whims of courts making inconsistent determinations.<sup>176</sup> On the other hand, a recent study has concluded that judges actually grant relief to a large percentage of the debtors who seek it, debtors can obtain such relief without an attorney, and their results appear to be rationally related to the direness of their financial condition.<sup>177</sup>

While these recent findings might suggest that the true problem with the current regime is debtors' reluctance to seek its protections,<sup>178</sup> one should be wary of generalizing this study's conclusions because so few debtors currently pursue undue hardship litigation. And notwithstanding the financial problems of the student loan debtor population in general,<sup>179</sup> the few debtors who do seek discharge are in noticeably worse financial condition than the many who do not.<sup>180</sup> This suggests not only that if judges apply the same methodology to the wider debtor population (assuming they even have a coherent methodology), debtor success rates will fall but also that the rate of relief among debtors who seek it is actually rather low and thus, that other debtors'

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<sup>171</sup> See NAT'L BANKR. REVIEW COMM'N, *supra* note 94, at 211; see also 124 CONG. REC. 1792 (1978) (statement of Rep. Ertel).

<sup>172</sup> See *supra* pp. 605–06.

<sup>173</sup> See, e.g., Lieber, *supra* note 19 (suggesting the number of annual undue hardship cases is under 1,000, which implies a filing rate of under 0.3% assuming about 390,000 debtors hold student loans, see *supra* p. 605); Iuliano, *supra* note 134, at 505 (estimating a 0.1% filing rate).

<sup>174</sup> See Pardo & Lacey, *supra* note 89, at 183, 185.

<sup>175</sup> See Braucher, *supra* note 5, at 472.

<sup>176</sup> See Pardo & Lacey, *supra* note 70, at 481.

<sup>177</sup> See Iuliano, *supra* note 134, at 525.

<sup>178</sup> See *id.*

<sup>179</sup> See *supra* p. 606.

<sup>180</sup> See Iuliano, *supra* note 134, at 510 fig.3, 524.

reluctance to pursue undue hardship litigation might in fact be warranted.

(c) *Costs.* — Conceding that § 523(a)(8) is not justified and that the undue hardship exception does not save it, one might still argue against repeal on cost grounds. After all, as perhaps over \$8.6 billion of educational debt declared in bankruptcy is not discharged<sup>181</sup> and the average recovery rate on consumer debt discharged in bankruptcy is close to 0%,<sup>182</sup> § 523(a)(8) might save creditors more than \$8 billion per year. Further, given the composition of the student loan market,<sup>183</sup> the bulk of this savings accrues to the federal government. So, one might contend that the government simply cannot afford to repeal § 523(a)(8).<sup>184</sup> But the federal student loan program is on its own likely profitable enough to withstand annual losses from repeal as it is projected to earn an average of over \$18 billion per year from 2013 to 2022.<sup>185</sup> Additionally, given the macroeconomic impact of educational debt,<sup>186</sup> repeal of § 523(a)(8) might boost the broader economy and thus federal tax revenue. Fears over costs therefore should not stand in the way of greatly needed reform.

#### IV. CONCLUSION

By repealing § 523(a)(8) and introducing risk-based pricing, the government can do much to help alleviate the current crisis in higher education economics. Rising higher education costs, soaring debt, growing defaults, and diminishing returns will certainly not disappear, but the government can take a step in the right direction with the proposals outlined in this Note. Such a step, like the status of a growing number of student loans, is long overdue.

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<sup>181</sup> For estimates of the amount of educational debt declared in bankruptcy and not discharged, see *supra* pp. 604–05.

<sup>182</sup> See VISA U.S.A. INC., CONSUMER BANKRUPTCY: CAUSES AND IMPLICATIONS 4 (1996), available at <http://govinfo.library.unt.edu/nbr/report/g2a.pdf> (estimating a recovery rate of 3%).

<sup>183</sup> See *supra* p. 590.

<sup>184</sup> To be sure, private lenders will also lose money from the elimination of § 523(a)(8), particularly if Congress extends repeal to existing loans, as recommended. But in thereby impairing existing contracts, the federal government will not impose unmanageable losses on private lenders, see CONSUMER FIN. PROT. BUREAU, *supra* note 24, at 74, and in any case, does not need to cover such losses because, unlike the states, it is not subject to the Contracts Clause, see U.S. CONST. art. I, § 10.

<sup>185</sup> Memorandum from Deborah Kalcevic & Justin Humphrey to Interested Parties, CBO March 2012 Baseline Projections for the Student Loan and Pell Grant Programs tbl.1 (Mar. 12, 2012), available at [http://www.cbo.gov/sites/default/files/cbofiles/attachments/43054\\_StudentLoanPellGrantPrograms.pdf](http://www.cbo.gov/sites/default/files/cbofiles/attachments/43054_StudentLoanPellGrantPrograms.pdf).

<sup>186</sup> See *supra* p. 606.