Not All Student Loans Are Created Equal – Some May Be Dischargeable in Bankruptcy

August 6, 2021

On July 15, 2021, in the *Homaidan*[1] opinion, the Second Circuit joined the Fifth[2] and Tenth[3] Circuits in deciding that certain student loans are dischargeable in bankruptcy. These three opinions are very important for the student loan industry but may not be as momentous as they seem on the surface, as they do not purport to render all student loans potentially dischargeable.

The question in these cases is whether the loans at issue qualified as "student loans" for the purposes of the Bankruptcy Code. Section 523(a)(8) states that certain debts commonly referred to as "student loans" are not dischargeable in bankruptcy unless they "would impose an undue hardship on the debtor and the debtor's dependents." (The "undue hardship" line of inquiry is itself complex and not relevant to these cases.) Broadly speaking, the debts exempt from discharge are those that involve (1) educational benefit overpayments or loans made with governmental involvement; (2) obligations "to repay funds received as an educational benefit, scholarship, or stipend"; or (3) other educational loans to individuals that qualify under the IRS tax code as "qualified educational loans." Until the last five or six years, most courts have held any student loan is presumed nondischargeable under the second prong, because all student loans involve an obligation to repay funds and confer an educational benefit.

The sea change is that courts are now analyzing the second prong in relation to the other two. Many are deciding that, had Congress intended for the second prong to cover actual loans, it would have been easy for Congress simply to include the term "loans" as it did in the other two prongs. Further, people usually do not describe loans as "educational benefits"; the term "benefit" is more commonly used in relation to scholarships or grants. These courts view nondischargeable debts in three broad buckets: (a) loans made with government involvement; (b) requirements to repay grants and scholarships (e.g., arising if the student fails to comply with the terms of a scholarship); and (c) private student loans that meet IRS guidelines that might render them tax deductible. Private loans that do not meet the IRS criteria are thus increasingly at risk of being discharged in a bankruptcy proceeding.

Some private student loans were made under programs that may not qualify for IRS preferred tax treatment. That makes these court decisions very important to the student loan industry, especially as some law firms seek to revisit treatment of student loans in bankruptcy cases from up to a decade ago. Many other loans, however, were made in accord with IRS guidelines and thus are unaffected by this revised approach to student loan review. Still others potentially would qualify for favorable tax treatment but for the debtor's misuse of the funds or other bad acts; these loans typically remain nondischargeable as well. Thus, although these Circuit court decisions are important, they are unlikely to revolutionize the student loan industry or resolve the reported student loan crisis.

Miller Canfield advises lenders in matters regarding student loans. Should you have any questions or wish assistance, please feel free to contact us.

[1] *Homaidan v. Sallie Mae, Inc.*, ___ F.4th ___, 2021 WL 2964217 (2d Cir. 2019 July 15, 2021).

[2] *Crocker v. Navient Solutions, LLC (In re Crocker)*, 941 F.3d 206 (5th Cir. 2019).

Continued

[3] *McDaniel v. Navient Solutions, LLC (In re McDaniel)*, 973 F.3d 1083 (10th Cir. 2020).