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The Misinterpretation of 11 U.S.C. § 523(a)(8)

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[1]The common belief that all student loans are protected from discharge in bankruptcy is based on a misunderstanding of 11 U.S.C. § 523(a)(8). Since 1990, bankruptcy courts have been misreading the statute to prevent any student debt that could be construed as providing educational benefits or advantages from discharge. The flawed logic in student bankruptcy cases has thus become (1) all debts that confer educational benefits are protected from discharge; (2) the debt in question facilitated the debtor's education and as such, conferred educational benefits; and (3) the debt is not dischargeable. This application was never intended by Congress. Section 523(a)(8) currently protects from discharge:

> (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
> (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
> (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986.

Importantly, each subsection of § 523(a)(8) addresses a different kind of debt, and practitioners cannot select useful terms from the many layers and so end by creating their own personalized version of § 523(a)(8). As the *In re Alibatya* court characterized this behavior, the "[d]efendant has sought to place [the] Plaintiff's ... obligation within virtually every category of excepted educational debt identified in 11 U.S.C. § 523(a)(8). Remarkably, at the same time, [the] Defendant blurs distinctions between such excepted categories, blending them under one overarching rubric, namely, educational benefit."[2]

However, the *Alibatya* court is almost unique in refusing this argument. Most bankruptcy courts have fallen victim to the *educational benefit* siren and have refused to discharge any debt that can be construed as providing broadly defined educational advantages. This interpretation is at odds with the statutory language and legislative history of § 523(a)(8), which protects three distinct classes of debt. First, subsection (A)(i) only protects federally insured or nonprofit student loans. Second, subsection (A)(ii) only protects debts resulting from noncompliance in contractual service scholarships and grants. Third, subsection (B) only protects *private* student loans that meet narrow Internal Revenue Code qualifications. A sizeable portion of private student loan debt falls outside all three of these categories, and must be treated as non-qualified private student loans that have no protection from discharge.

History of § 523(a)(8)

The history of § 523(a)(8) is closely tied to the federal government's commitment to higher education, which has two major programs. The first program offers federally insured, guaranteed or issued loans, such as the Stafford and Perkins loans.[3] The second program offers federal scholarships and grants, such as Veteran's Tuition Assistance and the National Health Service Corps Scholarship.[4] The impetus for § 523(a)(8) was largely to protect the government (and, by extension, the taxpayer) from students who took advantage of these programs to finance an education, and then filed for bankruptcy before

moving onto lucrative careers.[5]

Since its initial enactment, there have been three major amendments[6] to § 523(a)(8). These amendments added (1) the provision excepting from discharge all federally guaranteed and nonprofit loans in 1979,[7] (2) the clause excepting from discharge all governmental service scholarships in 1990[8] and (3) the subsection excepting qualified private student loans from discharge in 2005.[9]

In its original incantation, § 523(a)(8) only protected federally guaranteed and nonprofit loan programs. The following language protected from discharge any debt that was

> (a)(8) for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a nonprofit institution of higher education....[10]

Notably, the original wording of § 523(a)(8) failed to address the potential problems that were created by federal scholarships and grants. In the 1980s, the issue was first raised as to whether debts resulting from service scholarships were protected by the original language in § 523(a)(8). [11] In *U.S. Dept. of Heath and Human Services v. Smith*, a student accepted a medical school scholarship on condition that he work in a "physician shortage" area for a certain number of years after graduation.[12] The student finished medical school but failed to satisfy the condition and thus incurred *an obligation to repay funds received as an educational … scholarship*. The student then filed for bankruptcy and sought to discharge the resulting obligation, arguing that the pre-1990 language in § 523(a)(8) rendered only *loans* nondischargeable. The bankruptcy and district courts held that the scholarship was not a loan, and therefore was dischargeable. However, the Eighth Circuit felt that a contingent scholarship debt was the near enough equivalent of a "loan" and reversed the lower court's decisions and prohibited discharge.[13]

Despite the Eighth Circuit's ruling, Congress was not entirely insensitive to this problem of interpretation and added a new clause to the existing statute, "or for an obligation to repay funds received as an educational benefit, scholarship, or stipend." The language after 1990 protected from discharge any debt:

> **(a)(8)** for an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution, or for an obligation to repay funds received as an educational benefit, scholarship or stipend....[14]

The new language was designed to remedy the problem of conditional scholarships and Congress even provided specific examples to illustrate the meaning of the new language. "This section [523(a)(8)] adds to the list of nondischargeable debts, obligations to repay educational funds received in the form of benefits (such as VA benefits), scholarships (such as medical service corps scholarships) and stipends. "[15] These examples offer critical evidence of congressional intent. For example, Congress used the word "benefit" to mean a VA benefit, which is incompatible with the broader interpretation of "benefit" as any money lent to further a debtor's education.[16]

The rise in commercial lending in the student loan market led for-profit lenders to seek similar protection from bankruptcy discharge.[17] Congress acquiesced, and in 2005, § 523(a)(8) underwent further changes. First, the statute's original provision was bifurcated into two subsections, §§ 523(a)(8)(A)(i) and 523(a)(8)(A)(ii). Second, subsection (B) was added to protect qualified private student loans from the discharge. After 2005, the language protected any debt for the following:

> (A)(i) an educational benefit overpayment or loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution; or
> (ii) an obligation to repay funds received as an educational benefit, scholarship, or stipend; or
> (B) any other educational loan that is a qualified education loan, as defined in section 221(d)(1) of the Internal Revenue Code of 1986.[18]

The Misinterpretation of § 523(a)(8)(A)(ii)

Despite the plain meaning of the statute and the legislative history, many courts have misread "obligation to repay funds received as an educational benefit" to mean that any loan that facilitates or furthers a debtor's education is protected from discharge. Inherent in this error is a misreading of two pieces of the statute: "obligation to repay funds" and "benefit." First, courts are substituting the word "loan" for the phrase "obligation to repay funds."[19] Second, the term "benefit" is being interpreted to mean those educational advantages provided by a student loan.[20]

However, a growing number of courts have realized the difficulty of the resultant logic: Interpreting "educational benefit" to except from discharge any loan that in any way facilitates education renders the remaining provisions of the statute meaningless. If any money lent to any person for any educational

purpose is protected, then the remaining provisions of § 523(a)(8) — provisions carefully crafted to protect federally insured loans, nonprofit loans and other loans qualified by the IRC — become superfluous.[21]

The first error occurs when courts treat the phrase "obligation to repay funds" as synonymous with "loan." This occurred most notably in *In re Rumer*, in which the court created a summary of § 523(a)(8) that has been cited by later courts:[22]

> [Section] 523(a)(8) protects four categories of educational loans from discharge: (1) loans made, insured, or guaranteed by a governmental unit; (2) loans made under any program partially or fully funded by a government unit or nonprofit institution; (3) *loans received as an educational benefit, scholarship, or stipend*; and (4) any "qualified educational loan" as that term is defined in the [IRC].[23]

Notice how for the sake of symmetry, the *Rumer* court substituted the word "loan" for the phrase "obligation to repay funds" in the third part, thereby changing the meaning of the law. Benefits, scholarships and stipends are not loans. They are grants of money that are sometimes coupled with service obligations, which if not fulfilled result in an obligation to repay. Such conditional obligations may have attributes in common with loans, but the terms are not interchangeable.

Once the courts reclassified "obligation to repay funds" as "loans," they were forced to treat the phrase "educational benefit" as some sort of adjective-modifying loan. Thereafter, the whole focus of the analysis shifted from determining whether a debt *was an educational benefit* to determining whether the debt *was a loan that conferred education benefits*. This formula forged the words "loan" from subsection (A)(i) and "educational benefit" from subsection (A)(ii) into a single statutory chimera found nowhere in the statute's language. As a court in Michigan held, "the loans from Northstar are 'obligations to repay funds received as an educational benefit' under § 523(a)(8)(A)(ii)."[24] A Massachusetts court similarly held that "under the plain language of 11 U.S.C. § 523(a)(8)(ii), the August 2007 Agreement is a loan for an educational benefit."[25]

The Misapplication of § 523(a)(8)(B)

The problem with this misreading of § 523(a)(8)(A)(ii) is serious because it improperly serves as a catch-all provision to protect from discharge any and all debts that provide vaguely defined educational advantages. Now, some of the debts that are getting caught in the § 523(a)(8)(A)(ii) web might still be excepted from discharge under (1) § 523(a)(8)(A)(i) because they are federally insured or nonprofit loans, or (2) they might be excepted under § 523(a)(8)(B) because they are qualified private loans that meet the narrow IRC § 221(d)(1) qualifications.

However, IRC § 221(d)(1) sets forth specific requirements that are not met by every private student lender or loan. Subsection (B) protects only "qualified educational loans" (QEL) as defined in IRC § 221(d)(1). A QEL is defined as "any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses."[26] "Qualified education expenses" are in turn defined as "the cost of attendance at an eligible educational institution."[27] "Cost of attendance" is defined as "tuition, books and a reasonable allowance for room and board (as defined by the institution)."[28] The "cost of attendance" "as defined by the institution" must adhere to a federal methodology that calculates the full cost of attendance for a given school in a given area. No loans in excess of that calculated amount may be qualified.[29] Thus, any money lent to a student who has already reached his/her federal limit under the qualified "cost of attendance" is a nonqualified private student loan and has no protection from discharge under § 523(a)(8).

The problem arises when bankruptcy courts use the "educational benefit" language to bypass performing a thorough analysis of private student loans under the IRC. The most extreme example occurred in *In re Carow*.[30] In that case, a debtor sought to discharge her private student loans because they had been lent in excess of the qualified limits. "Dave Hanson ... the associate director of financial aid ... testified that [the] Debtor was awarded the maximum federal loan amount for which she was eligible and *that Chase's loans could not have been certified because they were above and beyond [the] Debtor's eligibility*."[31] The court disagreed, reasoning that even if the loan was in excess of federal limits, it was enough that the debtor had affirmed in the contract that the money would be used for qualified educational expenses.[32] However, the court hedged its holding and somewhat flippantly held that "[m]oreover, even if the loans were not a qualified educational loan as defined in 26 U.S.C. § 221(d)(1) for purposes of section 523(a)(8), subsection (a)(8)(A)(ii) provides that it is enough that the debt at issue be 'an obligation to repay funds received as an educational benefit.'"[33]

Conclusion

Since 1990, courts have misread the phrase "educational benefit" to protect from discharge any debt that has an *educational purpose* or otherwise furthered a debtor's educational pursuits. Such overbroad interpretations have abrogated the fresh start for thousands of debtors and provided commercial lenders with protections from discharge in circumstances that were never intended by the Bankruptcy Code. Nonqualified private student loans have no protection from discharge in bankruptcy. Furthermore, the

Consumer Financial Protection Bureau reported that more than 31 percent of student debtors between 2005-07 took out private loans in amounts that were not certified by the institutions.[34] This does not necessarily mean these loans are not qualified under the IRC — but with more than $150 billion in total outstanding private student loan debt, this issue demands closer scrutiny.

1. Special thanks to Prof. Lois R. Lupica (University of Maine School of Law; Portland, Maine), Bill Wilson and Marschall Smith. The views expressed in this article do not necessarily represent the views of Bickel & Brewer.

2. *In re Alibatya*, 178 B.R. 335, 338 (Bankr. E.D.N.Y. 1995).

3. Federal Student Aid, *Loans*, *available at* https://studentaid.ed.gov/types/loans (last visited May 20, 2014).

4. Federal Student Aid, *Grants and Scholarships*, *available at* https://studentaid.ed.gov/types/grants-scholarships (last visited May 20, 2014).

5. H.R. Rep. No. 95-595, at 133.

6. Space precludes a discussion of every amendment to § 523(a)(8). The three amendments discussed herein are the most significant to the issues addressed in this article.

7. P.L. 96-56 (Aug. 14, 1979).

8. P.L. 101-647, 104 Stat. 4789 (1990). This clause was later made its own subsection in 2005.

9. P.L. 109-8 (April 20, 2005).

10. *Supra* n.7.

11. *See also In re Lipps*, 79 B.R. 67 (Bankr. W.D. Fla. 1987); *In re Avila*, 53 B.R. 933, 937 (Bankr. W.D.N.Y. 1985).

12. 807 F.2d 122 (8th Cir. 1986).

13. *Id*. at 126-217.

14. *Supra* n.8.

15. Federal Debt Collection Procedure of 1990: Hearing on P.L. 101-647 Before the H. Subcommittee on Economic and Commercial Law, H. Judiciary Committee 101st Cong. 74-75 (June 14, 1990) (Mr. Brooks' Questions for the Record from Mr. Wortham).

16. The congressional record even cited *In re Smith* as impetus for the change.

17. 145 Cong. Rec. H2655-02, at Part 3 of 5 on WL (May 5, 1999) (this act was ultimately defeated in 1999, but language was subsequently incorporated into Bankruptcy Abuse Prevention and Consumer Protection Act of 2005).

18. *Supra* n.9.

19. *In re Rumer*, 469 B.R. 553 (Bankr. W.D. Pa. 2012); *In re Oliver*, 499 B.R. 617, n.3 (Bankr. S.D. Ind. 2013); *In re Beesely*, 2013 WL 5134404, at *3 (Bank. W.D. Pa. 2013).

20. Consider that the word "benefit" has two common meanings. The first is "an advantage or profit gained from something." The second is "a payment made by an employer, the state or an insurance company." Courts have been using the former, but Congress clearly intended the latter. *Oxford Dictionaries*, *available at* www.oxforddictionaries.com/us.

21. *See, e.g., London-Marable v. Sterling*, 2008 WL 2705374, at *5 (Bankr. D. Ariz. 2008); *see also In re Segal*, 57 F.3d 342, 348 (3d Cir. 1999).

22. *See supra* n.19; *but see In re Corbin*, 506 B.R. 287, 291 (Bankr. W.D. Wash. 2013), wherein the court cited the passage but corrected the error.

23. *In re Rumer*, 469 B.R. 553 (Bankr. M.D. Pa. 2012).

24. *In re Maas*, 497 B.R. at 863 (Bankr. W.D. Mich. 2013).

25. *In re Belforte*, 2012 WL 4620987 (Bankr. D. Mass. 2012).

26. 26 U.S.C. § 221(d)(1).

27. 26 U.S.C. § 221(d)(2).

28. 20 U.S.C. § 1087ll.

29. Mark Kantrowitz, "Limitations on Exception to Discharge of Private Student Loans," at 5 (March 5,

2009), *available at* www.finaid.org/questions/bankruptcylimitations.pdf; *see also* CFPB, Private Student Loans 10 (Aug 29, 2012), *available at* http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf.

30. 2011 WL 802847 (2011); *see also In re Skipworth*, 2010 WL 1417964 (Bankr. N.D. Ala. 2010); *In re Roy*, 2010 WL 1523996 (Bank. D.N.J. 2010); *In re Beesely*, 2013 WL 5134404 (Bankr. W.D. Pa.).

31. *In re Carow*, 2011 WL 802847 at *2 (2011) (emphasis added).

32.. *Id.* at *4.

33. *Id.*

34. CFPB, Private Student Loans 3 and 51 (Aug. 29, 2012), *available at* http://files.consumerfinance.gov/f/201207_cfpb_Reports_Private-Student-Loans.pdf (major culprit here are "direct-to-consumer" loans that bypass institutions altogether).

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