Student-Loan Holders See New Path for Wiping Out Debt Through Bankruptcy

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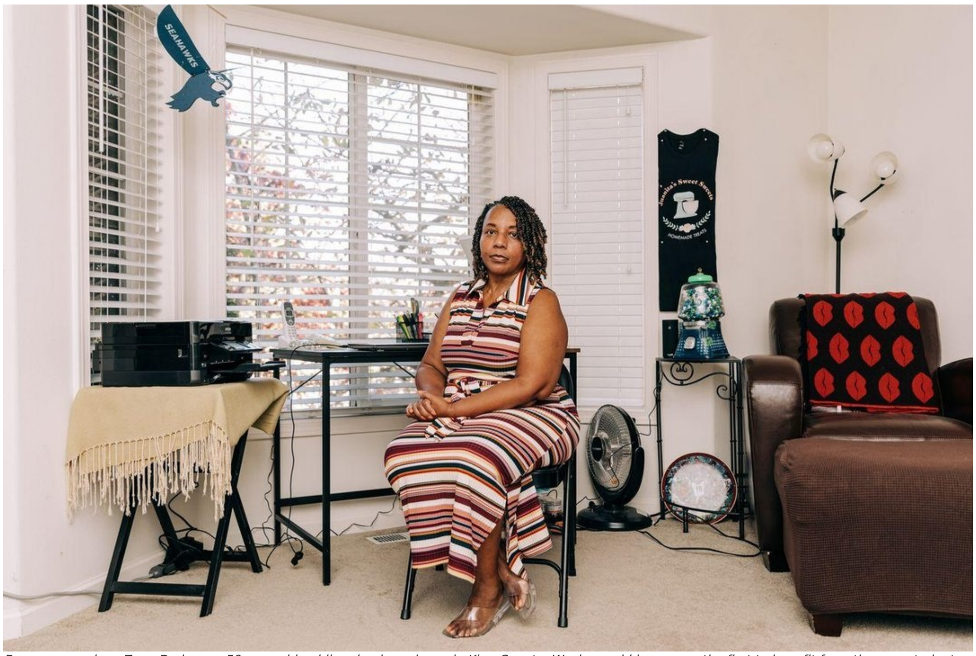
The Biden administration's decision to make it easier to discharge student loans in bankruptcy could offer a new safety valve for debtors who have exhausted other options for getting out from under heavy debt loads.



Borrowers such as Zena Dodson, a 59-year-old public school employee in King County, Wash., could be among the first to benefit from the new student-debt guidance./Photo by David Jaewon Oh for The Wall Street Journal

The move, announced Thursday, comes as President Biden's broader plan for mass student-debt cancellation is in limbo after being blocked by two separate federal courts. That plan calls for canceling up to $20,000 in debt for borrowers under certain income thresholds. It would render up to 20 million people free of debt, around half of all student-loan borrowers, if courts allow it go forward.

The bankruptcy changes set specific requirements for borrowers to prove that they are experiencing economic distress. Government lawyers will assess a borrower's ability to repay their loans based on a set formula—whether expenses equal or exceed a debtor's income—and other considerations, such as retirement age, disability, educational attainment and job history.

The scope of its impact will depend on how the new rules are applied by judges, lawyers and student-loan borrowers across the country in individual bankruptcy cases. Over time, the handling of these cases could differ depending on which party controls the White House.

"I can imagine that it will be applied unevenly across administrations with different attitudes toward loan cancellation," said Beth Akers, a higher-education expert at the American Enterprise Institute, a conservative think tank.

Borrowers such as Zena Dodson, a 59-year-old public school employee in King County, Wash., could be among the first to benefit from the new guidance.

Ms. Dodson said she took out less than $20,000 in federal loans in the late 1980s to attend a for-profit business school that closed before she got her degree. That balance has since ballooned to nearly $80,000, despite years of payments. Over the years, the balance weighed on Ms. Dodson as she cared for elderly family members and supported her children. She said she has worked secondary jobs in child care and eldercare for much of the past two decades to make ends meet.

In instances when she was faced with the choice of paying her student debt or putting food on the table, she said she always chose the latter. In 2014, Ms. Dodson successfully filed for chapter 7 bankruptcy protection. Her student loans weren't discharged because at the time she was unaware of the requirement that borrowers file a separate claim to start an "adversary proceeding"—something few borrowers do—though the ones that do have significantly higher success rates and often settle with their creditor, the Education Department.

"If you can prove that you have a total hardship, your student loans should be included in your bankruptcy," Ms. Dodson said. "I have tried everything that I possibly could do, getting a second job, to pay these student loans off, and it didn't work."

Last month, Ms. Dodson made another attempt to get her student loans discharged with the help of a local bankruptcy lawyer and an organization founded by former Education Department lawyers. The Justice Department is required to respond to her filing by Tuesday.

That makes her one of the first plaintiffs in a bankruptcy case to test the impact of the new legal guidelines.

"She was targeted by a for-profit college that closed more than two decades ago, but she has always tried to make her student loan payments," said Aaron Ament, a former senior lawyer at the Education Department and president of the National Student Legal Defense Network. "Zena is exactly who this new bankruptcy guidance is intended to help get a fresh start."

A senior Education Department official told Congress over a year ago that new bankruptcy guidelines were in the works. In March, Education Secretary Miguel Cardona tweeted, "we are working to change our policies so that bankruptcy is an option for those struggling with student debt," and said that any borrower currently going through bankruptcy proceedings should have the Justice Department pause their case so "every borrower can benefit from these changes."

But work on the guidelines dragged on, in part because the Biden administration was attempting to change so many parts of the student-loan system at once.

During that time, government lawyers continued to take a hard line in some student-loan borrower bankruptcy cases. In March, they opposed a bankruptcy discharge for a cancer patient, arguing that when she recovered, she would be able to hold a job again and pay off her debts. The approach continued up to this month, when Justice Department lawyers opposed discharges in cases in Missouri and Arizona.

The bankruptcy guidance joins a series of other piecemeal changes set in motion by the Biden administration, mostly through regulation, to overhaul federal student-loan programs. The administration has proposed or finalized new rules for income-based repayment plans and borrowers who work in public-service professions. They will revise the process for defrauded borrowers to receive loan cancellation, and restore millions of defaulted borrowers' loans to good standing.

"The piecemeal changes that Biden has implemented will affect millions of borrowers," Ms. Akers said. "But the total magnitude of those effects are just a small share of what the president would be achieving through the mass loan cancellation event that he has proposed."

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