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Bankruptcy and student loans

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If you have student loans you can't pay, you may feel like you're holding a degree from the school of hard knocks.

If you're starting to think bankruptcy is your escape, think again. Many government-backed student loans and school loans backed by nonprofit agencies are not discharged in a bankruptcy, which means whatever you owe has to be paid back after the bankruptcy.

You can rid yourself of student loans through a bankruptcy if they represent a substantial hardship -- but that is very difficult to prove.

To have a student loan discharged, you have to prove three things, says David Light, managing editor of *Consumer Bankruptcy News*, a Florida-based newsletter:

- You can't keep up with your payment schedule
- Your future inability to pay and that your financial situation is permanent
- You've made a good-faith effort to pay

Good faith efforts include being as fully employed as you can be, being upfront with the lender, and presenting evidence that when you had money you made payments. What courts don't like to see is that you were fully employed and didn't pay, or you used an inheritance to buy a car, Light says.

It is the most difficult to prove hardship when you first come out of school, primarily because you don't have any history of not repaying the loans.

How's the judge feeling?

There is a debate in the courts over whether student loans should be partially discharged during a bankruptcy. Some courts allow it, while others take a more absolute approach. It all hangs on the attitude of the bankruptcy judge, says Joni Anderson, associate general counsel for the USA Group Inc., a student loan guarantor and administrator in Indianapolis, Ind.

Prior to October 1998, if the borrower had made the first loan payment seven years ago, or if the loan repayment caused undue hardship, it could be discharged. Now, people can no longer dissolve their school loans through bankruptcy simply because the loans are old.

"We don't get nearly as many bankruptcy student loan cases as we did five years ago," says Connie Smith, a manager at Sallie Mae, a corporation that maintains student loans in Reston, Va.

The chapters

Even if you can't discharge your student loans through your bankruptcy, the lender can't bill you for the payments on them until the bankruptcy is over -- but interest still accrues. Light warns that if you don't make payments your situation could be even worse after the bankruptcy.

Alternatives to bankruptcy

So if you can't deal with a student loan problem through

When bankruptcy works:

bankruptcy, what can you do? There are many more repayment options for student loans than for any other type of loan. It is important to let the lender know you're having trouble making payments.

You may be able to discharge school loans from banks or individuals through bankruptcy if the government or a nonprofit institution is not backing them. But very few student loans are not government-guaranteed.

"Student loan borrowers are fearful of doing that," Anderson says. "They don't make an effort to contact the student-loan holder, and they should do that."

Most borrowers aren't trying to get out of paying their loans, it's just that they don't know what to do, Smith says. She adds that defaulting doesn't happen out of the blue, and if they talk to the lender early on, there's bound to be a plan that will work.

If the borrower has defaulted, Anderson suggests a rehabilitation program in which you make 12 consecutive payments for a lower amount to show good faith and be brought out of default, and then going back to paying the previous amount. Other options to bring student loans under control can include: consolidation, negotiating with the lender, and seeking help from a counseling service to get other debts in order so you can afford to pay the loan.

Loan consolidation

The Direct Loan Servicing Center, working under the auspices of the Department of Education, offers four types of repayment plans for federally funded or federally guaranteed student loans:

- The standard plan has a fixed payment amount of at least $50 until the balance is paid. It lasts as long as 10 years.
- The extended repayment plan lasts 12 to 30 years, depending on the amount owed. The longer you're in repayment the more you'll pay in interest.
- The graduated repayment plan offers a payment that equals the interest accrued since the last payment or one-half of the standard plan payment, whichever is greater. The payments increase every two years.
- The income contingent repayment plan calculates your payment based on your annual adjusted gross income, family size and amount of the direct loans. This plan can last for as long as 25 years. If you haven't paid the loans by then, the unpaid balance gets discharged, and you pay taxes on the discharged amount.

Even if you can't dissolve your debt, you might be able to make your life a bit easier if you can find a way to restructure your student loan.

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