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Key Bankruptcy Reforms In Reach, Whoever Wins Congress

By **Vince Sullivan**

Law360 (November 4, 2022, 7:03 PM EDT) -- The \$1 trillion student loan debt crisis and disputes over third-party releases have converged into a rare bipartisan issue for lawmakers, and the next Congress will be well positioned to address these issues through bankruptcy reform legislation, regardless of how the election turns out, experts say.

Democrats currently enjoy control of both houses of Congress and the White House, but have not been able or eager to push forward with major bankruptcy reforms over the past two years. In the absence of a legislative solution to the burgeoning student debt crisis, President Joe Biden enacted sweeping loan forgiveness via executive action earlier this year, but that move has stagnated over **legal challenges**.

Likewise, contentious nondebtor third-party releases have drawn interest in the current Congress, but concrete action has been hard to come by, even as circuit courts are mulling over the question of their appropriateness.

In the contest of student loan debt, a legislative fix that lowers the bar to obtain a discharge of educational loans in a bankruptcy case may be the easiest method to provide relief, Douglas G. Baird of the University of Chicago Law School told Law360.

Currently, getting a discharge of a student loan through a personal bankruptcy filing requires a showing of substantial hardship, a standard that has become increasingly difficult to meet. But Baird said a small change to the federal bankruptcy code could provide an opportunity to set a new bar.

"There should be an opportunity for Congress to come in and say, 'Let's push the reset button and give the courts a chance to define what it means to discharge student debts,'" Baird said.

With about \$1.75 trillion in outstanding student loan debt in the country, that silo of borrowing is now second only to home mortgage debt and has been recognized by candidates of both major parties as a critical issue ahead of the midterm elections.

The potential solutions to the crisis have become a focal point in some campaigns in the run-up to Election Day, with Biden's move to forgive student loans for some borrowers via executive action drawing criticism from across the aisle.

"It's totally become a partisan issue even though it probably shouldn't be," Jeremy R. Fischer of law firm Drummond Woodsum told Law360. Fischer also serves as co-chair of the American Bankruptcy Institute's legislation committee, which doesn't take positions on legislative proposals, and served three terms in the Maine Legislature as a Democrat.

Fischer agrees addressing student loan debt in a bankruptcy context may be a smaller pill to swallow for opponents of outright loan forgiveness, as the requirement to file bankruptcy to obtain a loan discharge means borrowers aren't getting away without consequences.

"I think if [Congress] focused on the bankruptcy side of it and looked at the scope of the discharge, that might be an easier place than forgiving the debt for everybody," he said. "With forgiveness, the criticism has been that it's too broad ... If you only did it for people who find themselves in bankruptcy, in a situation where they'll lose most of their assets and can only get relief through a

discharge, it will be much more targeted to people who actually need it."

Bipartisan support is possible, Baird said, because the economic realities of discharging student debts are obvious. The people who need the discharge the most aren't likely to be paying any of the borrowed loan back anyway, and eliminating the debt after a certain repayment window passes and there has been a showing of hardship would set these individuals on the right course financially.

"It would let the honest but unfortunate debtor start over again," Baird said. "We're not letting people off the hook, we're just recognizing reality."

Paul H. Zumbro, head of the restructuring department at Cravath Swaine & Moore LLP, said making it virtually impossible to discharge student debt was probably not the intention of legislators when they adopted the current version of the bankruptcy code. A change from Congress to address the issue could thread the needle between those concerned about giving borrowers a free ride and those worried about forcing borrowers to destitution, he said.

"To satisfy the standard for a discharge, you really have to be in dire straits," Zumbro added.

U.S. Bankruptcy Judge Laurie Selber Silverstein **issued an opinion** in earlier this year discharging about \$100,000 in student loan debt for a man who filed for Chapter 7 bankruptcy, saying his financial outlook was so dismal he would never be able to comply with a payment plan while maintaining a minimal standard of living. The debtor, Ryan K. Wolfson, graduated from Penn State University in 2010 with a business degree, but was never able to hold down any regular work, partly due to suffering from seizures. He had been depending on his father for financial support since graduating.

Zumbro said amending the standard for a student loan discharge to provide some kind of waiting period from the date of the loan to the discharge would provide a solution that could be embraced by legislators from either side of the aisle.

"It may not be a perfect way to do it," he said. "It might be more palatable to people opposed to forgiveness."

Another bankruptcy concept that has drawn proposals for legislative change in the current Congress involves nondebtor third-party releases that have been at the forefront of the recent wave of mass tort Chapter 11 cases. These provisions enforce a release of liability for nondebtors from other nondebtors, and have notably been deployed in the cases of debtors facing massive tort exposure like Purdue Pharma and the Boy Scouts of America.

In the Purdue case, the members of the Sackler family who own the company received releases from the thousands of opioid injury claimants seeking recovery from the debtor as part of a plan settlement that saw the family pay more than \$5 billion into a claim trust. The settlement drew vocal opposition from some claimants and legislators, with a bar on such releases proposed as part of HR 2096, or **the Sackler Act**, floated in March 2021 by Rep. Carolyn B. Maloney, D-N.Y. The bill garnered support from more than 60 Democratic colleagues, but has seen no legislative action since being referred to committee in October 2021.

Rep. Jerrold Nadler, D-N.Y., also proposed a bill to bar nondebtor releases in July 2021, which **made it to markup** in the House Judiciary Committee, but has otherwise remained stagnant since last November.

In the Purdue case, the releases **were unwound** by a New York federal judge after they were approved by the bankruptcy judge presiding over the case, but an appeal to the Second Circuit is **currently under advisement**, leaving the permissibility of third-party releases under a cloud of uncertainty as other circuit courts have taken opposing stances.

"It's a bomb waiting to go off," University of Chicago's Baird said of the release issue.

Legislative reform would nip the legal questions in the bud, he said, but the drive to get something done in Washington receded as inflationary concerns took the spotlight earlier this year.

"If that was going to happen, it would have happened a couple of months ago," Fischer, of Drummond Woodsum, said. "It seemed like it started to, but fell away as economic factors worsened."

A law that clarifies the standard for obtaining a third-party release would be the most helpful tactic to address concerns over the propriety of these provisions, Cravath's Zumbro said.

"There has been legislation proposed to preclude them or prohibit them, but I don't think that's the right answer," Zumbro said. "Adopting a uniform standard for third-party releases and what cases they'd be appropriate for would be really useful."

These releases are usually paired with a channeling injunction under Section 524(g) of the U.S. Bankruptcy Code that was adopted in 1994 to deal with a spate of asbestos bankruptcies and the need to address future injury liability. The releases and injunction have since been adopted in other mass tort cases that don't involve asbestos, muddying the waters about their applicability and how courts should examine their appropriateness.

But Baird said the fuse has already been lit, and the forthcoming decisions from the Second Circuit about the permissibility of these types of controversial releases could spur renewed action in Congress.

"A lot of these bankruptcy issues are issues where people of goodwill can actually come together and make the world a better place," he said.

Congress — even when controlled by the party in opposition to the White House — has shown it can move forward quickly with bankruptcy reforms when conditions create an emergent need for change, such as when the debt limit for small business debtors was raised during the COVID-19 pandemic. Seeing a need for small businesses to be eligible for Subchapter V cases, Congress moved with lightning speed to hike the debt cap to enable more struggling companies to take advantage of the more efficient Chapter 11 rules.

Subchapter V was established by the Small Business Reorganization Act of 2019 to allow businesses with less than \$2.7 million in debt to reorganize on an expedited schedule without the appointment of a creditors committee.

That debt increase is scheduled to sunset in June 2024 — after an extension was likewise **passed expeditiously** earlier this year — and Congressional action seems likely to either adopt another extension or perhaps make the new cap permanent.

Comprehensive bankruptcy reforms, such as the reconfiguration of consumer bankruptcy rules **proposed** by Sen. Elizabeth Warren, D-Mass., and Nadler in September, are less likely to be pushed through the legislature, especially in light of prior efforts fizzling quickly. Baird said there doesn't seem to be a tidal shift in the restructuring world like that brought by the pandemic, but that economic uncertainty can lead to change.

"There is always a rise in bankruptcy, not just when times are bad but also when times change," he said. "We are living in changing times, so you can expect a lot of bankruptcy activity. With that activity comes unhappiness and potential pressures for change. It wouldn't shock me if there was bipartisan support for that change."

--Editing by Lakshna Mehta.