

# Eligibility for Borrowers in Bankruptcy



The Bankruptcy Act of 1994 prohibits a school (or lender) from denying a Title IV loan (Direct Loan or Perkins loan) to an applicant based solely on the applicant's filing of a bankruptcy petition. So what are the requirements for the financial aid office when a student or parent applicant files — or filed — bankruptcy?

If the student (or parent) has a loan outstanding that is included in a bankruptcy action, may the school originate a new loan? May the school originate other types of Title IV assistance?

Maybe. Note the following:

- ♦ If the loan was not in default when the student (or parent) filed the bankruptcy action, then the bankruptcy action itself has no effect on the borrower's eligibility for the Stafford, PLUS or Perkins loan and the school must originate the new loan despite the bankruptcy. The school also must award and disburse other Title IV funds for which the student is eligible.
- ♦ If the loan defaulted prior to the filing of the bankruptcy action, then that default causes the student (or parent) borrower to be ineligible for additional Title IV funds — of any kind, including loan funds — until the default is resolved.

## **If the student files bankruptcy before the school originates a Stafford loan:**

- ♦ The school must originate the loan if the student is otherwise eligible. The school may not originate the loan for an amount that is less than the student's eligibility, based solely on the bankruptcy.

## **If the student files bankruptcy before the school originates a Grad PLUS loan:**

- ♦ The school must originate the loan if the student is otherwise eligible. The school may not originate the loan for an amount that is less than the student's eligibility, based solely on the bankruptcy.
  - Note that if the student has adverse credit, the loan may be denied if the denial is not based solely on the bankruptcy. The student may obtain a creditworthy endorser to overcome the adverse credit denial.

## **If the parent files bankruptcy before the school originates a parent PLUS loan:**

- ♦ The school must originate the loan if the student and parent are otherwise eligible. The school may not originate the loan for an amount that is less than the student's eligibility, based solely on the bankruptcy.
  - Note that if the parent has adverse credit, the loan may be denied if the denial is not based solely on the bankruptcy. The parent may obtain a creditworthy endorser to overcome the adverse credit denial.
- ♦ If the loan is denied and the parent does not obtain an eligible endorser — or if the parent secures from the bankruptcy court a letter that states the parent is not permitted to incur additional debt — the school may originate additional unsubsidized Stafford loan funds for the otherwise dependent student.

## **If the student or parent files bankruptcy after the school originates the loan but before the Title IV loan funds are fully disbursed:**

- ♦ The school must continue to disburse the loan funds despite the bankruptcy action.
- ♦ A borrower is not required to endorse a new Master Promissory Note in order to obtain a new Direct Stafford PLUS or Perkins loan after the date of any bankruptcy action.

## **If a school is aware that a student or parent borrower has filed a bankruptcy action:**

- ♦ The school should suspend any activities that might be construed as attempts to collect on any outstanding loan until the bankruptcy action ends.

USA Funds® also recommends that each school consult its legal counsel as it develops its own policies and procedures for administering loans on which a bankruptcy action is pending.