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Trustee Litigation Trend: Tuition Clawback

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"An investment in knowledge always pays the best interest." Benjamin Franklin, *The Way to Wealth: Ben Franklin on Money and Success* (1758). For parents paying their adult child's college education costs, however, this investment may not be worth (to them) the cost of tuition — at least according to some bankruptcy courts. With increasing frequency, chapter 7 trustees are looking to insolvent parents as well as colleges and universities to avoid and recover for estate creditors payments made by insolvent debtors for the benefit of the debtors' dependents. These cases are premised on the theory that the tuition payments being made by insolvent parents for the benefit of their children are avoidable as constructively fraudulent transfers because the parents do not receive reasonably equivalent value in exchange for the payment of such tuition. The principal issue in these cases is whether the payment of a child's tuition provides reasonably equivalent value to the insolvent parents. Courts are divided, with some holding that parents do receive reasonably equivalent value for the tuition payments and others holding that the parents do not. The courts that find reasonably equivalent value do so by finding economic value conferred upon the parents. *See, e.g., Sikirica v. Cohen (In re Cohen)*, 2012 Bankr. LEXIS 5097 28-29 (Bankr. W.D. Pa. 2012); *see also*, *DeGiacomo v. Sacred Heart Univ., Inc. (In re Palladino)*, 556 B.R. 10 (Bankr. D. Mass. 2016). In contrast, the courts that do not find reasonably equivalent value do so based on the absence of legal responsibility on the part of the parents to educate their child. *See, e.g., Gold v. Marquette Univ. (In re Leonard)*, 454 B.R. 444 (Bankr. E.D. Mich. 2011); *see also*, *Banner v. Lindsay (In re Lindsay)*, 2010 Bankr. LEXIS 1554 (Bankr. S.D.N.Y. 2010). Recent decisions in the Second Circuit adopt the reasoning of the latter line of decisions and hold that the value analysis turns whether there is a legal obligation to educate. *See, e.g., Mangan v. Univ. of Conn. (In re Hamadi)*, 597 B.R. 67 (Bankr. D. Conn. 2019); *Pergament v. Brooklyn Law Sch. (In re Adamo)*, 595 B.R. 6 (E.D.N.Y. 2019); *In re Sterman*, 594 B.R. 229 (Bankr. S.D.N.Y. 2018). Another issue that arises in tuition clawback litigation cases, particularly where the universities are defendants, is whether, and to what extent, the educational institutions may be considered initial transferees or mere conduits.

Tuition Payments As Constructively Fraudulent Transfers

Section 548(a)(1)(B) of the Bankruptcy Code empowers a trustee to avoid a transfer of an interest in property of the debtor under a constructive fraud theory to set aside transactions that improperly deplete a debtor's estate. *See*, 11 U.S.C. §548(a)(1)(B). A constructive fraudulent transfer has two basic elements: 1) whether reasonably equivalent value was received by the debtor; and 2) insolvency. The Bankruptcy Code does not define "reasonably equivalent value"; however, the term "value" is defined and is given an economic meaning. Specifically, the Bankruptcy

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Code provides that "value" means "property, or satisfaction or securing of a present or antecedent debt of the debtor, but … not … an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. §548(d)(2)(A). Similarly, courts have held that bonds of love and affection do not constitute reasonably equivalent value. *See*, *e.g.*, *Harris v. Burrell (In re Burrell)*, 159 B.R. 365, 370 (Bankr. M.D. Ga. 1993); *see also*, *Kramer v. Mahia (In re Khan)*, 2015 U.S. LEXIS 133241 42 (E.D.N.Y. 2015). Whether the debtor received "reasonably equivalent value" is unique in the tuition clawback cases because when a parent pays tuition of a child, the child receives the direct benefits of an education, a degree, and eventual employment. Thus, it must be determined whether: 1) the parent receives *any* value at all for paying tuition for an adult child; and 2) whether that value constitutes "reasonably equivalent value." The courts that have examined the issue have considered whether the parents had a legal obligation to provide financial support or an education for their children as dispositive of value being provided.

Equivalent Value

Tuition payments made to or for the benefit of an adult child may change the analysis and may be deemed to be less than reasonably equivalent value. Last year, the Bankruptcy Court for the Southern District of New York rejected the debtor-parents' argument that they received an economic benefit from paying the education costs of their adult children because paying for an adult child to obtain an undergraduate degree will enhance such child's financial well-being which will in turn confer an economic benefit on the parents. *See*, *Sterman*, 594 B.R. 229. In *Sterman*, the bankruptcy court held that such asserted economic benefit did not constitute value under the New York Debtor Creditor Law or the Bankruptcy Code. The court in *Sterman* explained that arriving at this value conclusion was not a simple matter. 594 B.R. 229, 236. In contrast, tuition payments made to or for the benefit of minor children differ in that the parents satisfy their legal obligation to educate their child and in doing so they received reasonably equivalent value and fair consideration. The age of majority is determined by applicable state law and, therefore, a different result may have been reached had the facts of *Sterman* been governed by Connecticut law, providing that the age of majority is 18 as opposed to New York law under which the age of majority is 21. 594 B.R. 229, 236.

Mere Conduit Defense Available to Universities

Once a transfer has been successfully avoided under section 548 of the Bankruptcy Code, "the trustee may recover, for the benefit of the estate, the property transferred" from either "the initial transferee of such transfer" or "any [subsequent] transferee of such initial transferee." 11 U.S.C. §550. A trustee may not, however, recover from a subsequent transferee "that takes for value …, in good faith, and without knowledge of the voidability of the transfer avoided." 11 U.S.C. §550(b)(1). Thus, even where the court finds there was less than reasonably equivalent value, a trustee's recovery of tuition from universities under a constructive fraud theory may turn on whether the universities are initial transferees or immediate transferees of initial transferees. *See*, 11 U.S.C. §550(a). To qualify as an initial transferee, existing caselaw distinguishes between the initial *recipient* — the first entity to touch the transferred funds — from the initial *transferee*. Courts have held that the minimum requirement for status as a "transferee" is dominion over the money or other asset and the right to put the money to one's own purposes. *See*, *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890 (7th Cir. 1988); *Christy v. Alexander & Alexander Inc. (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)*, 130 F.3d 52 (2d Cir. 1997). Courts in the Second Circuit have held that an entity is not an initial transferee if it was a "mere conduit" of the funds. *Finley*, 130 F.3d 52; *Bear, Stearns Sec. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1 (S.D.N.Y. 2007); *Authentic Fitness Corp. v. Dobbs Temp. Help Servs., Inc. (In re Warnaco Group., Inc.)*, 2006 U.S. Dist. LEXIS 4263 18-19 (S.D.N.Y. 2006).

Applying this definitional framework to the context of tuition clawback cases, courts have held that for a university to qualify as an initial transferee, it must have

exercised dominion over the money or other asset and the right to put the money to its own purpose. *See*, *e.g.*, *Hamadi*, 597 B.R. 67; *see also*, *Adamo*, 595 B.R. 6. In January, the United States Bankruptcy Court for the District of Connecticut ruled that to the extent a university receives tuition payments made through a university's payment portal and prior to the time when such payments are applied to a student's tuition costs and are deemed non-refundable, the university acts as a mere conduit of such payments and not an initial transferee subject to the clawback provisions of sections 548 and 550 of the Bankruptcy Code. *See*, *Hamadi*, 597 B.R. 67.

In the *Hamadi* case, the Bankruptcy Court for the District of Connecticut held that the *refundable* tuition payments were not recoverable transfers of property. 597 B.R. 67. The refundable payments in *Hamadi* were placed in an account maintained by UConn but they remained the property of the student and the university did not have the right to use the tuition payments for its own purposes. In essence, UConn acted as an intermediary through its maintenance of an Online Portal for student tuition payments pursuant to which the student was the initial transferee and UConn served as a mere conduit who did not have dominion and control over tuition payments until the student enrolled — at which time the monies were applied to the student's account and the university became an immediate transferee. Once the deadline to withdraw from school had passed, the schools were actually owed the tuition and then became creditors.

In another case decided this past January, the Eastern District of New York held that the bankruptcy court's rulings that the universities did not become initial transferees until the students enrolled and the deadline to withdraw had passed was sound; however, the court remanded the case to the bankruptcy court for more detailed findings with regard to the timing of the tuition payments at issue. *See*, *Adamo*, 595 B.R. 6.

Conclusion and Key Takeaways

A review of the tuition clawback cases recently decided by courts in the Second Circuit reveals that the successful defense of such claims may turn on whether the payments sought to be avoided: 1) were made for the benefit of minor children or, to the extent they were not; and 2) were refundable — thereby never becoming property of the university — during the relevant time periods in question. Broadly viewed, though, these types of claims give rise to not only bankruptcy, but socio-economic and public policy debates. While the rising cost of tuition has been cited as a cause for the increase in trustee clawback litigation (because previously such claims did make economic sense to trustees), the costs associated with universities defending tuition clawback litigation may result in a further increase in education costs. Additionally, these types of claims may interfere with a student's ability to complete her education to the extent tuition is clawed back and remains unpaid. Unless section 548 of the Bankruptcy Code is amended to address and circumscribe these types of claims (in 2015, such a bill was proposed. *See*, Katy Stech, "Bill Proposes Ban on Tuition Clawbacks in Bankruptcy," *Wall St. J.: Bankr. Beat* (May 12, 2015) (https://on.wsj.com/2NOMTUs, sub. req), this type of litigation will continue to frustrate honest debtors' efforts to obtain a fresh start as well as legitimate efforts to ease the financial burden on students resulting in students graduating with more — rather than less — debt.

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