

Western Massachusetts/  
Connecticut Region

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### Tuition Clawbacks

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W I G G I N   A N D   D A N A

## What is a Tuition Clawback?

- A letter or lawsuit from a parent's bankruptcy trustee
- Demanding that an institution return tuition paid before the parent's bankruptcy



## What is a Tuition Clawback?

- All tuition clawbacks are based on the concept of Fraudulent Transfer
  - College students (over 18) are legally adults, so they are responsible for paying tuition, not their parents
  - If parents pay tuition, they are paying someone else's debt & not getting **Reasonably Equivalent Value (REV)**
  - If parents are insolvent when tuition is paid, and they later file for bankruptcy, the payments may be vulnerable to attack as fraudulent transfers

## Trustee can recover tuition payments made by:

- Cash or check
- Credit card
- Direct PLUS Parent Loans
- A combination of all 3 sources



## 2 Ways Trustees Can Recover Fraudulent Transfers

- Directly, using remedies in the Bankruptcy Code
- Indirectly, through the Uniform Fraudulent Transfer Act (UFTA) or other state debtor-creditor laws

**UFTA**

## Direct Remedy under Bankruptcy Law

- Section 548 of the Bankruptcy Code has a 2-year reach back
- Trustee can seek tuition payments made during the 2 years immediately preceding the bankruptcy



## Indirect State Law Remedy

- Section 544 of the Bankruptcy Code is called the ***Strong Arm Provision***
- Allows trustee to access rights of a judgment creditor under state law
- Trustee can use the reach back period of state where the parent filed the bankruptcy, even if college is in another state



## Reach Back Periods Under State Law

- Most states have a reach back period longer than 2 years
- 4 year reach back in MA & CT under UFTA
- 6 year reach back in New York; not adopted the UFTA



## What is the legal theory behind Clawback claims?

### ■ Fraudulent Transfer Law



- Ancient & fundamental part of debtor-creditor law, which allows creditors to “avoid” or unwind transactions thought to unfairly deplete a debtor’s assets
- Transactions subject to “avoidance” traditionally included real estate and personal property transfers
- New debt, such as guaranties, notes, and even credit card charges, can also be “avoided”

## Fraudulent Transfer Law

- There are 2 strands of modern Fraudulent Transfer law-- Actual Fraud & Constructive Fraud
- At common law, it was really hard to prove actual fraud, so the theory of constructive fraud was added
- In tuition clawback cases, Trustees usually sue under both theories of fraudulent transfer
- Trustee does not necessarily have to prove intentional fraud to win a tuition clawback case

## Actual Fraud

- Transfers made with “actual intent to hinder, delay or defraud creditors”
- Debtors rarely admit to fraudulent intent, so a body of law arose called “Badges of Fraud,” a list of objective factors indicating probable fraud



## Constructive Fraud

- Based on the maxim that a person should be just before being generous
- Transaction made for less than **REV** can be unwound, if **debtor was insolvent** at the time of transfer, or became insolvent as a result
- **REV** is the essence of all constructive fraud cases, but is not defined in the statutes

## Reasonably Equivalent Value

- **REV** is judge-made law; unsettled & evolving
- “Value” has been held to mean a direct or indirect economic benefit to the parents
- Some courts have ruled that educating a student doesn’t constitute **REV** because there’s no law requiring parents to pay for college
- Other judges say parents & adult children are one economic unit; a college education is **REV** because it is reasonable & necessary for maintaining the family

# Insolvency

- Fraudulent transfer claims often hinge on a determination of insolvency
- Solvent parents can pay tuition without risk of clawbacks



## Definitions of Insolvency

- Balance sheet test
  - Liabilities exceed assets, at fair value
- Equitable test
  - Not paying debts as they become due gives presumption of insolvency under the UFTA



## What should you do if you get a tuition clawback demand letter?

- Ask for additional time to respond
- Get copies of all cancelled checks and other proof of payments
- Check the Trustee's claimed payments against your records
- Contact the family to get all the facts



## How can you protect your institution from getting tuition clawback demands?

- Insist that tuition payments come directly from the student
- Make sure 3<sup>rd</sup> parties payors (parents, grandparents, family businesses) are solvent



## How can you protect your Institution from getting tuition clawback demands?

- Accept payments from 529 or Coverdell Plans, which are partially protected
  - Funds deposited more than a year before the bankruptcy are not considered part of the parent's bankruptcy estate



## Payments From College Savings Plans

- Limited protection for payments from funds deposited between 1 & 2 years before the bankruptcy filing--up to \$6,225/student
- No limit on payments from 529 or Coverdell accounts for funds contributed more than 2 years before bankruptcy

## Proposed PACT Legislation – Protecting All College Tuition (H.R. 2267)

- Intention of PACT is to create an exception from bankruptcy avoidance actions (clawbacks) for “good faith” tuition payments by parents
- Introduced last May by N.Y. Rep. Chris Collins (R); (H.R. 2267); Co-sponsors: Blake Farenthold (R-TX), Doug Collins (R-GA), Luke Messer (R-IN)

## Status of Proposed PACT Legislation

- Referred to House Subcommittee on Regulatory Reform, Commercial & Antitrust Law in June



## Drafting Problem with PACT Legislation

- Would only protect direct clawbacks under Bankruptcy Code § 548
- PACT doesn't provide an exemption for indirect claims brought under state law using the Strong Arm Provision (Bankruptcy Code § 544)
- State law claims usually have a 4 year reach back, so unless PACT is amended, it won't really protect any tuition payments at all!

# QUESTIONS



# Thank you!

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