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When a Parent Files for Bankruptcy Colleges May Forfeit Tuition Payments

Imagine that the Bursar's Office receives the following letter:

"I am the chapter 7 bankruptcy trustee for John J. Smith, Sr. ("Debtor"). Based on my review of the Debtor's transactions with your institution over the past four (4) years, it appears that you received tuition payments totaling \$200,000 on behalf of John J. Smith, Jr., the Debtor's adult child ("Student"). These payments are "fraudulent transfers" under both the Bankruptcy Code and the Uniform Fraudulent Transfer Act ("UFTA"), so please send me a check to reimburse Debtor's bankruptcy estate for these tuition payments. If payment is not received by next Friday, I will sue you for \$200,000 in the bankruptcy court in my home jurisdiction."

While it is hard to imagine that a college or university could be forced to refund tuition paid years ago that enabled Student to receive a college education, this scenario is now playing out with increasing frequency. Many colleges and universities are unprepared to respond to such demands. Some institutions ignore these letters as shakedowns and face litigation in far-off federal courts. Other universities pay the trustee, but are unable to recover the lost tuition from a student who has since graduated. The best way to protect against this type of threat is to understand the bankruptcy trustee's legal argument and to build an arsenal of defenses to it.

THE LEGAL REASONING

Generally, once a child reaches the age of 18, a parent no longer has any legal support obligations.^[1] Accordingly, the parent has no legal duty to pay for his or her adult child's college education. Indeed, most colleges and universities implicitly recognize this by billing the student for tuition, not the parent, even if the parent ultimately pays the invoice. When a parent pays for an adult child's tuition, he or she is essentially making a gift to the child. However, if the tuition is paid directly to the educational institution, the college or university, not the child, becomes the target if the parent later files for bankruptcy. The bankruptcy trustee can claim that the tuition payments were "fraudulent transfers" under both state law and the Bankruptcy Code. The remedy provisions of both the state and federal laws allow the trustee to claw back the tuition payments from the institution.

Fraudulent transfer law recognizes two types of voidable transfers – those based on "actual fraud" (i.e. a debtor's deliberate intent to hinder, delay or defraud creditors), and those grounded in "constructive fraud" (i.e. transfers made while the debtor was insolvent, which were made without the debtor receiving "reasonably equivalent value").^[2] Actual fraud is rarely a serious concern in college tuition claw back actions. Such cases are notoriously time consuming and costly to pursue. Instead, a bankruptcy trustee is likely to rely on the argument that the tuition payments

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constituted constructive fraud, a much easier case to make. As a general rule, to prove that tuition paid within four years of the date of the parent's bankruptcy filing was constructively fraudulent, all the trustee needs to show is that the parent received less than "reasonably equivalent value" in exchange for the payment and that the parent was insolvent at the time, or became insolvent as a result of the payment.[3]

Since the student, not the parent, goes to college and receives the education for which the tuition is paid, several courts have ruled that the parents did not receive "reasonably equivalent value" for the tuition payments.[4] *In Gold v. Marquette University (In re Leonard)*[5], the court rejected the argument that parents received "reasonably equivalent value" in the form of a "substantial benefit conferred upon parents when their child is educated," stating that "speculative and unquantifiable claims of psychological benefits" could not meet the university's burden of proving "reasonably equivalent value"[6].

Although some recent decisions have suggested a movement toward acknowledging that it has become "something of a societal expectation"[7] for parents to help their children pay for college, there are no appellate court rulings requiring a bankruptcy judge to take into account the benefit of an adult child's education to the parent, leaving such tuition payments vulnerable to attack as fraudulent transfers.

RESPONDING TO TRUSTEE DEMAND LETTERS – A CHECKLIST

Given the lack of controlling authority establishing that an adult child's college education constitutes "reasonably equivalent value" to a debtor parent, a college or university should marshal additional arguments in response to the bankruptcy trustee's demand. Here's our checklist of issues to consider upon receipt of a fraudulent transfer demand letter:

- **Request Itemized Proof of Each Tuition Payment to Compare With School Records.** Demand letters often reference the total tuition payments over the course of the student's college career, but the college or university should insist that the bankruptcy trustee provide proof of each alleged fraudulent transfer payment, including fronts and backs of checks. The institution should compare each payment sought by the trustee with its own records to confirm the amount and source of payment. Bankruptcy trustees often rely on incomplete or inaccurate records provided by the debtor, including checks that were ultimately dishonored, or checks from a non-debtor related party, such as the family business.
- **Determine the Student's Age at the Time of Each Tuition Payment.** If the student was a minor at the time of any tuition payments, the college can argue that the debtor parent did have a legal support obligation for such semesters and that those payments were not fraudulent transfers.
- **Determine the Solvency of the Parent at the Time of Each Tuition Payment.** Constructive fraud is based on the premise that the parent was insolvent at the time of the tuition payment (i.e. his or her liabilities exceeded his or her assets, at fair value). Over a four-year period, it is entirely possible that some of the tuition payments sought by the bankruptcy trustee were made before the parent suffered a financial setback, and are therefore not recoverable as fraudulent transfers. For example, one university was sued for tuition payments made from 2009 through early 2013. The parents owned business and commercial properties in New Jersey that were devastated by Hurricane Sandy in October 2012, forcing them into bankruptcy in early 2013. A review of the publicly available financial filings in the parents' bankruptcy case revealed that the parents were clearly not insolvent before the storm. Using this information, the university argued that the pre-October 2012 tuition payments were immune from attack because the parents were not insolvent before Sandy hit and persuaded the trustee to accept a minimal settlement.
- **Determine the Original Source of the Funds.** As the court recognized in *In Re Leonard*, "when a debtor holds property in trust for another, and makes a pre-petition transfer of such property, the transfer is not subject to avoidance as a fraudulent transfer under Bankruptcy Code § 548." [8] Determine whether the attacked tuition payments might have been a mere pass-through of funds from a source other than the parents. For example, if the student's grandparents wrote a check for tuition, the parents deposited the check into their account and then paid tuition, the institution may

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be able to argue that a trust had been created and that payment could be immunized from attack. The institution should also ask the family whether tuition funds came from a student's earnings, grants or scholarships that belonged to the student but were deposited into the parent's account for convenience.

■ Negotiate With the Bankruptcy Trustee.

Feel free to request more time to seek additional information necessary to evaluate the trustee's demand letter or to retain counsel. Bankruptcy trustees have limited resources and many cases to handle, so they may be willing to compromise to maximize the overall recovery in the estate while minimizing litigation costs.

AVOIDING THE DEMAND

Unfortunately, tuition fraudulent transfer actions are a relatively new problem in the bankruptcy arena and the body of law is not yet fully developed. Nonetheless, colleges and universities might consider implementing a few practices that could reduce the risk of becoming a target.

First, educational institutions could require that all tuition payments come directly from the student or pre-approved third parties (scholarship funds, educational trusts, etc.). This one change alone could eliminate fraudulent transfer arguments arising from a parent's bankruptcy. If the tuition is paid by the student, even where the debtor parent has gifted the money to the student, the university is protected from a fraudulent transfer claim because no payments were made by the debtor directly to the

university. While the bankruptcy trustee would still have a claim against the student, as a practical matter, the trustee will probably not go after a college student or young graduate who has limited resources, so both the student and the university would be better off in the long run.

Additionally, colleges and universities that continue to accept payments from parents could require financial statements, including a balance sheet, at the time of each tuition payment, to confirm that the parents are in fact solvent. Since the commonly relied upon Free Application for Federal Student Aid (FAFSA) form does not include liabilities, educational institutions cannot rely upon FAFSA forms to determine the solvency of parents each time they make a tuition payment. Understandably, requiring parents to submit balance sheets in addition to FAFSA forms may be awkward, but taking this step could shield the institution against fraudulent transfer claims if the parents later file for bankruptcy.

A LEGISLATIVE SOLUTION?

The growing problem of bankruptcy trustees trying to recover tuition payments as fraudulent transfers has recently come to the attention of some members of Congress. On May 12, 2015, Congressman Chris Collins of New York introduced the Protecting All College Tuition Act (PACT Act). This bill, if enacted, would protect educational institutions from suits to recover tuition payments paid in good faith by parents who later file for bankruptcy. For more information or assistance with a bankruptcy trustee demand letter, please

contact Sharyn Zuch (szuch@wiggin.com), head of Wiggin and Dana's Bankruptcy Insolvency and Creditors' Rights Practice Group or Aaron Bayer, Partner in and Chair of Wiggin and Dana's Education Practice Group.

[1] There may be instances where a parent is legally required to provide for an adult child pursuant to a family court order in a divorce case or other circumstances which fall outside the scope of this article.

[2] See e.g. Bankruptcy Code Section 548(A) and (B), 11 U.S.C. § 548(A) and (B); Connecticut General Statute Sections 52-552e and 52-552f, Connecticut's version of The Uniform Fraudulent Transfer Act. See also Bankruptcy Code Section 544, 11 U.S.C. § 544, which gives the bankruptcy trustee the ability to use state fraudulent conveyance law.

[3] Id. The look-back period under the Bankruptcy Code itself is only two years, but, under Bankruptcy Code Section 544, the bankruptcy trustee can take advantage of the longer look-back period provided under most state fraudulent transfer laws, usually four years.

[4] See Gold v. Marquette University (In re Leonard), 454 B.R. 444 (Bankr. E.D. Mich. 2011); In re Godios, 333 B.R. 644 (Bankr. W.D.N.Y. 2005) (court ordered refund of tuition payments).

[5] 454 B.R. 444 (Bankr. E.D. Mich. 2011).

[6] Id at 459.

[7] See, e.g., Shearer v. Oberdick (In re Oberdick), 490 B.R. 687, 712 (Bankr. W.D. Pa. 2013).

[8] In re Leonard, 454 B.R. at 450-451.