Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Rejecting Tuition Payment Clawback: A Logical Result

By **James T. Bentley, Schulte Roth & Zabel LLP**
October 20, 2017, 5:37 PM EDT

When the parent of a child who attends private school files for bankruptcy, the school may be sued to return tuition payments for the benefit of the parent's creditors. Recently, a bankruptcy court dismissed with prejudice two complaints alleging that tuition payments made before a parent's bankruptcy are fraudulent transfers and should be "clawed back."[1] In dismissing these complaints, the court relied upon case law holding that a parent and his or her children must be considered a "single economic unit," and thus tuition payments made to private schools (even while the parent is insolvent) cannot be recovered. The court also held that the tuition payments do not unjustly enrich the schools at other creditors' expense because the parent receives the same benefit as his or her children.[2]

Background

In these cases, a mother was sending her two children to different private schools when she filed for bankruptcy. The Chapter 7 trustee sued the schools and sought to recover the tuition payments made to the schools before she filed for bankruptcy. In both cases, the trustee essentially asserted that (1) the tuition payments were constructive fraudulent transfers because they were made for less than fair consideration while the parent was insolvent, (2) the schools were unjustly enriched by the payments because the parent did not receive any consideration (the children were the beneficiaries), and (3) the parent made the payments with the intent of hindering, delaying and defrauding her creditors. The schools, in separate adversary proceedings, moved to dismiss the trustee's complaints.

Holding

The bankruptcy court sided with the private schools and dismissed the Chapter 7 trustee's suits with prejudice. With respect to the constructive fraudulent transfer claim, the trustee argued that fair consideration must be measurable and not a "subjective equation," and thus, the debtor "did not receive [fair consideration] because satisfying her legal obligation to educate her children did not yield a concrete economic benefit to [her] at the time of the transfer."[3] Moreover, the trustee argued, the parent could have sent her children to public school. The court disagreed, holding that children and their parents must be considered "a single economic unit" for purposes of determining fair consideration. Thus, the parent necessarily benefited from the children's education and received fair consideration. Further, the court held that the consideration given in exchange for the transfer need not be mathematically equal, or penny for penny, and that parents were not required to pay the lowest possible amount for their children's education. The court concluded that it was not a Chapter 7 trustee's role to second-guess how a parent spends his or her money prior to filing for bankruptcy.

Regarding the unjust enrichment claim, the trustee argued that the schools unfairly benefited from the tuition payments and were unjustly enriched as a result. The court dismissed this count because there was no evidence that the schools had benefited unfairly, charged more than their standard tuitions, or provided anything less than adequate education to the parent's children.

Finally, regarding the intentional fraudulent transfer claim, the trustee argued that the parent made the payments to the schools in order to hinder, delay or defraud her creditors. The court dismissed this claim because it found that the trustee had not alleged facts that showed, or even suggested, that the parent had an ulterior motive or purpose other than the education and care of her children when she made the tuition payments.

Takeaway

These cases are significant because they provide private schools with well-reasoned opinions on which to rely should a trustee seek to recover as fraudulent transfers a parent's pre-bankruptcy tuition payments. There are other theories under which a trustee may attempt to recover a parent's pre-bankruptcy tuition payments that are not addressed by these opinions, such as asserting that the payments are so-called "preferences,"[4] which are beyond the scope of this article.

Importantly, we do not view these cases as a departure from general corporate law, which provides that a parent corporation is not responsible for the liabilities of its subsidiary. For example, assume that a parent holding company pays for services provided to its subsidiary and subsequently files for bankruptcy. A trustee who asserted that the parent corporation did not receive fair consideration in exchange for its payment of the subsidiary's obligations, because the parent derived no direct benefit, likely would succeed in its argument.

There is an exception, however, to the general rule that a parent corporation is not responsible for its subsidiary's liabilities. If a party in interest can "pierce the corporate veil" of the parent and subsidiary companies, then the party may be able to demonstrate that the parent did, in fact, receive fair consideration in exchange for the payments it made on behalf of its subsidiary.

Piercing the corporate veil describes an action against a company that ultimately leads to the corporate structure being disregarded and liability being imposed on the company's owners. Generally, to pierce the corporate veil a party must demonstrate that the company at issue is a mere instrumentality or alter ego of the owners or parent corporation. In that sense, it is similar to the bankruptcy concept of "substantive consolidation," in which the assets and liabilities of related entities may consolidated. Once consolidated, the creditors of each entity share in the assets of the combined company on a pro rata basis. One of the primary factors courts consider in a substantive consolidation analysis is whether the related entities are "mere instrumentalities" or "alter egos" of one another.

Piercing the corporate veil and substantive consolidation are extreme remedies, which emanate from a court's equitable powers. There are numerous tests that courts have derived to determine whether the corporate veil should be pierced or related companies substantively consolidated; however, most tests share some common factors. For example, both remedies may be imposed if creditors of the subsidiary can show that they believed they were dealing with a single company (the parent) and not distinct entities. If the parent and the subsidiary are, in fact, a single entity, then the question of whether the parent received fair consideration in exchange for payment of its subsidiary's liabilities is mooted.

While "piercing the corporate veil" and "substantive consolidation" are not discussed in the context of these school tuition cases (because the cases address a parent and child rather than a corporation and its subsidiary), the bankruptcy court held that the parent and child were viewed by the private schools as a single economic unit and not as distinct individuals. This is the logical result, as a party delivering services to a child must understand that the parent ultimately is responsible for payment for such services. Accordingly, like corporations whose veil is pierced or are substantively consolidated into a single entity, the parent necessarily received a benefit from the child's education.

In sum, these cases should give some measure of comfort to other businesses, such as hospitals and other medical providers, that provide services to children.

James T. Bentley is a special counsel at Schulte Roth & Zabel LLP in the firm's New York office.

[1] In re Michel (Geltzer v. Woodmere), Adv. No. 16-01121, 2017 WL 4158331 (Bankr. E.D.N.Y. Sept. 18, 2017); In re Michel (Geltzer v. Trey Whitefield School), Adv. No. 16-01122, 2017 WL 4159952 (Bankr. E.D.N.Y. Sept. 18, 2017).

[2] See, e.g., In re Michel (Geltzer v. Woodmere), 2017 WL 4158331 at *9, (citing Geltzer v. Xaverian High School, 502 B.R. 124 (Bankr. E.D.N.Y. 2013)).

[3] In re Michel (Geltzer v. Woodmere), 2017 WL 4158331, at *5.

[4] A "preference" is a payment made by a debtor to or for the benefit of a creditor on account of antecedent debt owed by the debtor while the debtor was insolvent and made on or before 90 days prior to the filing of the debtor's bankruptcy petition. Insolvency in this instance means that the debtor's liabilities exceed the debtor's assets. There are several defenses a creditor may assert to an alleged preferential transfer, including that the payment was made in the ordinary course of business or the payment was a contemporaneous exchange for new value.
