ALERTS

Lower Courts Wrestle with Debtors' Tuition Payments

December 12, 2018

Two courts have added to the murky case law addressing a bankruptcy trustee's ability to recover a debtor's tuition payments for their children. In *Geltzer v. Oberlin College, et al.*, 2018 WL 6333588 (Bankr. S.D.N.Y. Dec. 4, 2018), a New York Bankruptcy Judge permitted a trustee to claw back payments that parents made to their financially independent adult children for college-related costs. In *Pergament v. Brooklyn Law School, et al.*, 2018 WL 6182502 (E.D.N.Y. Nov. 27, 2018), a District Court held that schools may assert a "good faith" defense for tuition payments received *before* the student enrolls in classes, but not those payments received *after* the student has enrolled.

Geltzer v. Oberlin College, et al.

Facts. Two parents ("Parents") filed joint Chapter 7 petitions. Asserting fraudulent transfers, the trustee sued to recover the debtor's payments made to (i) their two daughters ("Daughters") to help cover education-related costs, (ii) Oberlin College and (iii) a student loan servicer. Oberlin and the student loan servicer settled for $11,319, but the Daughters did not. The Daughters, who had received $25,627 in the six years[1] prior to their Parents' bankruptcy filing, were the remaining defendants.

The trustee alleged that the Parents received no "reasonably equivalent value" in exchange for the tuition payments. In response, the Daughters asserted that their Parents received an economic benefit because a college degree would make them financially self-sufficient.

The parties limited their cross-motions for summary judgment to a single issue: whether the Parents had received reasonably equivalent value for the tuition payments. *Id.* at *1. The parties stipulated as to certain facts: (i) some of the transfers were made to one of the Daughters ("S") before she was 21 (New York State's age of majority), and some were made thereafter, and (ii) all of the transfers made to the second Daughter ("A") were made "*after* she was 21, … *already graduated from college*," and financially independent. *Id.* at *1 (emphasis in original).

Court's Analysis. The Bankruptcy Code ("Code") does not define "reasonably equivalent value," but case law provides guidance. *Id.* at *3. "Reasonably equivalent value" does not ordinarily require the exchange to be mathematically equal, but "[p]urely emotional benefits, such as love and affection," will not suffice. *Id.* (citation omitted). Rather, courts consider both direct and indirect benefits. *Id.* (citation omitted).

The Parents' tuition payments fell into three categories: (i) transfers made *after* the Daughters were 21, (ii) transfers made to S *before* she was 21 and (iii) transfers made to A *after* she graduated from college. *Id.* at *4. The court held that the Parents received no value for payments they made (i) to the Daughters after they were 21 and (ii) to A after she graduated from college. *Id.* But payments to S before she was 21 were proper. *Id.*

The court was constrained by the definitions of "value" and "fair consideration" in the Code and in the New York Debtor & Creditor Law, which require either the transfer of property or the satisfaction of a present or antecedent debt. *Id.* (citations omitted).[2] The Parents, it reasoned, received neither benefit after their Daughters turned 21, the age of majority, because the Parents no longer had a duty under New York law to support the Daughters. In sum, the court did not question the Parents' decision to pay for their Daughters' college education, but found that any economic benefit identified by the Daughters after they had turned 21 did not constitute "value" under New York law or the Code. *Id.* at *6.

Parents are not required to pay college tuition for a minor child, said the court, but cited cases holding that parents had properly satisfied their legal obligation to educate their children. *Id.* at *6-7. "To hold otherwise would permit a trustee to scrutinize debtors' expenditures for their children's benefit, and seek to recover from the vendor if, in the trustee's judgment, the expenditure was not reasonably necessary, or if the good or service could have been obtained at a lower price, or at no cost,

elsewhere … . A trustee is not granted veto power over a debtor's personal decisions, at least with respect to pre-petition expenditures." *Id.* at *6-7.

Comment

Oberlin is consistent with current lower court decisions in the Second Circuit. See, *e.g.*, *In re Lindsay* 2010 WL 1780065 (Bankr. S.D.N.Y. 2010) (tuition payments for debtors' son voidable; unclear as to son's age; no obligation to pay tuition). It affirms, though, that parents are deemed to receive value in exchange for educating their *minor* children. *Oberlin* merely holds that parents do not receive value in exchange for their financially independent *adult* children's education.

The Parents in *Oberlin* had approximately $756,104 in debt. Of this amount, approximately $129,200 was owed to governmental taxing authorities for trust fund taxes. In the Stipulated Facts, the trustee acknowledged that "[a]ny money recovered from the Debtor's daughters will be used to pay: (a) … their parents' [priority] non-dischargeable tax debt after the payment of Trustee fees and professional fees and expenses; or (b) as [the trustee] asserts, administrative and other creditors according to the scheme provided in the Bankruptcy Code." [Case No. 18-1015; Dkt. No. 21, Stipulated Fact No. 31.] Therefore, the parties agreed that, other than the trustee, his professionals and the governmental taxing authorities, no other creditors will receive a distribution. Nevertheless, the trustee and his attorneys engaged in more than nine months of litigation with other litigants reaching settlements with Oberlin and the loan servicer that will provide $11,317.02 to the estate. If the Daughters ultimately pay the amounts the trustee claims ($23,351) after further litigation, he may recover for the estate a total of $34,668.02 before his own fees. After payment of the Trustee's statutory fee (roughly $3,966.80),[3] legal fees and accounting fees, the remainder of the recovered money, if any, will be paid to the governmental taxing authorities.

Pergament v. Brooklyn Law School, et al.

The debtor in *Brooklyn Law* had sustained a multimillion dollar judgment for fraud. From 2009 until his 2014 bankruptcy filing, the debtor paid tuition to separate colleges on behalf of his two children. While his bankruptcy case proceeded, he continued to pay his children's tuition payments to two colleges and, later, to one of the children's law school.

The schools all treated the tuition payments in the same way. "[A]ny payments received, from whatever source, were placed in [each] student's school account; funds were only applied toward tuition, and transferred to the school's general account, upon the student's registration for classes; in the event the student withdrew from the program, the student received the refund of any balance in the account." 2018 WL 6182502, *2. Only the student had access to this money once it was deposited in his or her account until the student enrolled in classes. Once the student enrolled, the student account was debited by each school.

Bankruptcy Court Litigation. The Trustee sued the children's two colleges and the law school (collectively, the "Schools") to recover all of the debtor's tuition payments.[4] According to the trustee, the debtor's tuition payments were fraudulent transfers under both the Code and New York law because the insolvent debtor did not receive reasonably equivalent value.

When the trustee avoids a constructively fraudulent transfer, it may recover the transferred property or its value from (a) the "initial transferee" or the entity for whose benefit such transfer was made, or (b) any "subsequent transferee" of the initial transferee. Code §550(a). If a *subsequent* transferee takes the property in "good faith," however, then Code §550(b) bars a trustee from recovering the property.

In March 2018, the bankruptcy court granted summary judgment dismissing the trustee's complaint. In that court's view, whether the tuition payments were constructive fraudulent transfers was irrelevant. The "undisputed facts establish that the Debtor's children were the initial transferees of the Debtor's transfers," and "the [Schools, as subsequent transferees] are entitled to the good faith defense provided by § 550(b)." 2018 WL 6182502, *2 (citation omitted).[5] The trustee appealed.

*District Court Appeal***.** The sole question on appeal was whether the Schools were "initial" transferees or "subsequent" transferees entitled to the good faith defense. The Trustee admitted that the Schools received the funds in good faith. Like "reasonably equivalent value," the Code does not define "initial transferee," requiring courts to fill the void. 2018 WL 6182502, *2; *see also Bear, Stearns Sec. Corp. v. Gredd (In re Manhattan Inv. Fund Ltd.)*, 397 B.R. 1, 14 (S.D.N.Y. 2007) (the Code does not define terms "transferee" or "initial transferee" and there is no helpful legislative history). In *Bonded Fin. Svcs. v. European Am. Bank*, 838 F.2d 890, 893

(7th Cir. 1988) ("*Bonded*"), the Seventh Circuit held that "the minimum requirement [to be an initial transferee] is dominion over the money or other asset, the right to put the money to one's own purposes. When A gives a check to B as agent for C, then C is the 'initial transferee'; the agent can be disregarded." *Id.* at 893. The Seventh Circuit explained that "an entity does not have legal dominion over the money until it is free to invest that money in lottery tickets or uranium stocks." *Id.* at 894. The Seventh Circuit's analysis is referred to as the "dominion and control test."

The Second Circuit adopted *Bonded*'s dominion and control test with what it called the "mere conduit" test. *Christy v. Alexander & Alexander of New York (In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey)*, 130 F.3d 52 (2d Cir. 1997). Effectively, the "mere conduit" test frames the *Bonded* "dominion and control" test in the negative. *Manhattan Inv. Fund*, 397 B.R. at 14. Rather than stating that a party is an initial transferee if it exercises "dominion and control" over the funds, the Second Circuit held that a party is *not* an initial transferee if it is a "mere conduit" of the funds. *Id.* at 15 (emphasis added). "A 'mere conduit'... has no dominion or control over the asset; rather, it is a party with actual or constructive possession of the asset before transmitting it to someone else. Mere conduits can do no more than transmit a transferor-debtor's funds to a transferee." 2018 WL 6182502, *3 (citation omitted).

Tuition Payments Made Before the Students Enrolled in Classes. The District Court first addressed the debtor's payments made to the Schools *before* the students had enrolled in classes. It held that the Debtor's children were not contractually obligated to do anything: "rather, until they registered for classes, they had the discretion to do whatever they wanted with the transferred money." 2018 WL 6182502, *6. The District Court rejected the trustee's argument that the debtor's children lacked dominion and control over the money in their student accounts, holding that it "didn't matter whether the children knew that they had the right to keep the money." 2018 WL 6182502, *6 (citation omitted).

Finally, the trustee argued a person who receives payments (the children) that are earmarked for a third party (the Schools) is a mere conduit. 2018 WL 6182502, *7 (citing *Tardif v. St. John the Evangelist Catholic Church (In re Engler)*, 497 B.R. 125 (Bankr. M.D. Fla. 2013)). Again, the District Court disagreed because the debtor made payments to the Schools, stating that the payments were for the benefit of his children. 2018 WL 6182502,

*7. In sum, each student could have withdrawn from school prior to enrolling in classes and the Schools would have been obligated to refund the payments to the students, but not to the debtor. Therefore, the debtor's children were the initial transferees of those funds, and not the Schools.

Tuition Payments Made After the Students Enrolled in Classes. As the District Court wryly noted, however, "in this appeal, timing is everything." 2018 WL 6182502, *9. Because the record from the bankruptcy court did not detail the timing of the tuition payments, said the District Court, further evidence was needed to show that the tuition payments had been made before the Debtor's children registered for classes. 2018 WL 6182502, *10. If the Debtor made tuition payments *after* the students had registered for classes, then the Schools, and not the students, would be the initial transferees. Once the Schools debited the student accounts, they were free to do with the money as they wished.

Comment

Brooklyn Law did not address whether the parents received reasonably equivalent value or if the transfers to the Schools were fraudulent transfers. If *Oberlin* is any indication, then tuition payments made by the parents *before* the children reached 21 should not be voidable as fraudulent transfers.

These cases lead to draconian results for innocent schools. Schools accept tuition payments in exchange for an intangible service—teaching. When schools are required to disgorge tuition payments, they are worse off than a seller of goods who may seek to reclaim its goods under section 2-702 of New York's Uniform Commercial Code. The innocent schools have nothing to reclaim.

The appellate courts may soon confront this social dilemma. A legislative solution would be more effective, though. *See e.g.*, Religious Liberty and Charity Donation Protection Act 1998, Pub. L. No. 105-183 (1998) (amends Code's fraudulent transfer provisions to prevent trustee from challenging good faith charitable gifts; "transfer of a charitable contribution to a qualified religious or charitable entity … shall not be considered to be a [constructively fraudulent transfer… . ").

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If you have any questions concerning this Alert, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] Six years is the New York law statute of limitations for fraud. NY CPLR 213(8).

[2] The Code expressly excludes from the definition of "value" an "unperformed promise to furnish support to … a relative of the debtor." 11 U.S.C. § 548(d)(2)(A).

[3] Chapter 7 trustees are entitled to 25 percent of the first $5,000 they recover that is disbursed, and 10 percent of the next $45,000.

[4] The trustee sought, as constructively fraudulent transfers, the tuition payments made *before* bankruptcy and, as unauthorized post-petition transfers, the tuition payments made after bankruptcy. 2018 WL 6182502, *2, fn. 3.

[5] The trustee also asserted that the tuition payments were voidable under New York law because they were made without "fair consideration" while the debtor was a defendant in an action for money damages; because a judgment had been entered against him; and because he failed to satisfy the judgment. *Id.* at *2, fn. 5 (citing N.Y. Debt. & Cred. Law § 273-a). Because the Schools were entitled to the good faith defense, the bankruptcy court did not address this claim by the trustee.

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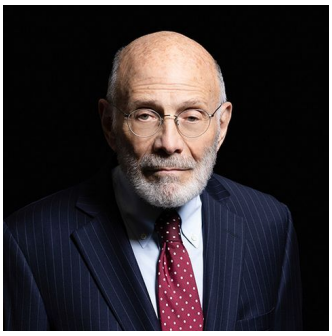

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