

## ALERTS

## First Circuit Allows Bankruptcy Trustee to Recover College Tuition Payments

November 15, 2019

An insolvent parent's college "tuition payments... depleted the [debtor's] estate and furnished nothing of direct value to the [debtor's] creditors..." held the U.S. Court of Appeals for the First Circuit on Nov. 12, 2019. *In re Palladino*, 2019 WL 5883721, \*3 (1st Cir. Nov. 12, 2019). Reversing the bankruptcy court on a direct appeal, the First Circuit rejected its reasoning "that a financially self-sufficient daughter offered [the debtor parents] an economic benefit." *Id.* at \*2. Instead, held the First Circuit, because the tuition payments were fraudulent transfers, the trustee "is entitled to avoid the tuition payments" and recover them from the college. *Id.* at \*3n. 5.

### Relevance

"Tuition payments made by insolvent parents have divided the courts," said the Court of Appeals, "although the recent cases have mostly ruled for trustees." See *Geltzer v. Oberlin College, et al.*, 2018 WL 6333588 (Bankr. S.D.N.Y. Dec. 4, 2018) (trustee permitted to claw back payments that parents made to their financially independent adult children for college-related costs); *Pergament v. Brooklyn Law School, et al.*, 2018 WL 6182502 (E.D.N.Y. Nov. 27, 2018) (schools may assert a "good faith" defense for tuition payments received before a student enrolls in classes, but not those payments received after student has enrolled). The National Association of Bankruptcy Trustees filed an amicus brief for the trustee here, as did the American Council on Education and others for the appellee college.

The college defendant in *Palladino* accepted tuition payments in exchange for an intangible service —teaching the debtor’s children. When schools are required to disgorge tuition payments, they are worse off than a seller of goods who may seek to reclaim those goods under the Uniform Commercial Code. Innocent schools and colleges have nothing to reclaim.

*Palladino* is the first fraudulent transfer/tuition payment case to be handed down by any federal Court of Appeals. Because the court relied on the fraudulent transfer provisions of the Bankruptcy Code (“Code”) and because Congress “made the trade offs which are set forth in the statute, courts must enforce those statutes. Absent constitutional challenge, when confronted with a clear statutory command like the one in the Code, that is the end of the matter.” *Id.* at \*3, citing *TVA v. Hill*, 437 U.S. 153, 194 (1978).

## Facts

The debtor parents paid roughly \$65,000 in college tuition for their 18-year-old daughter between 2012 and 2014. In 2014, the parents were convicted for fraud in operating a Ponzi scheme and subjected to a \$9.7-million civil judgment obtained by the Securities and Exchange Commission. They filed a Chapter 7 petition in April 2014, when the bankruptcy trustee was appointed. The trustee sued the college to avoid and recover the tuition payments under federal and state fraudulent transfer law, but “the only issue on appeal” was the trustee’s constructive fraud claim under Code §548 (transfer by insolvent debtor for less than “reasonably equivalent value”). *Id.* at \*2.

## The Bankruptcy Court

The bankruptcy court, in disposing of cross motions for summary judgment, held that having “a financially self-sufficient daughter” constituted “reasonably equivalent value” under Code §548(a)(1)(B)(i). Under Massachusetts law, where the parents were domiciled, and under Connecticut law, where the defendant college was located, “the age of majority...” is 18. 2019 WL 5883721, at \*1n. 1.

## The Court of Appeals

The court stated the rationale for avoiding fraudulent transfers: “the law prohibiting fraudulent transfers protects creditors from transactions undertaken by the debtor prior to bankruptcy... which deplete the pool of assets that would eventually be available to satisfy the creditors’ claims.” *Id.* “Such a [fraudulent] transfer operates to prioritize the friend or family member over bona fide creditors, which in turn ‘violates the principle, be just, before you are generous.’” *Id.* quoting *Bos. Trading Grp., Inc. v. Burnazos*, 835 F.2d 1504, 1508 (1st Cir. 1987) (Breyer, J.).

Relying on Code §548(a)(1)(B)(i), dealing with constructively fraudulent transfers, the court stressed that an insolvent debtor’s transfer “made... within two years before” bankruptcy for “less than a reasonably equivalent value” is voidable. *Id.* at \*2. “Reasonably equivalent value” is “not defined in the statute,” said the court, “but it does not include intangible, emotional and non-economic benefits.” *Id.* citing *Tavener v. Smoot*, 257 F.3d 401, 408-09 (4th Cir. 2001).

Fraudulent transfer law is intended to “preserve the debtor’s estate for the benefit of unsecured creditors,” explained the court. *Id.* “Courts evaluate transfers from the creditors’ perspective... measuring value at the time of the transfer.” *Id.*

The First Circuit’s reasoning in *Palladino* is “straightforward.” *Id.* at \*3. “The tuition payments here depleted the estate and furnished nothing of direct value to the creditors who are the central concern of the Code provisions at issue.” *Id.* Because the college could show no value being conferred on the parent debtors, and because the parent debtors were “under [no] legal obligation to pay college tuition for their adult children,” the college had to return the tuition payments. *Id.* at \*3n. 4. Nevertheless, if state law had required the expenditure, the outcome might have been different. *Id.* The college “invoke[d] a ‘societal expectation’ that parents will pay college tuition for their adult children, but... this does nothing for the creditors.” *Id.* The court would reach the same result for payments to “elderly parents or needful siblings.” *Id.* at \*3.

## Comment

*Palladino* may lead to draconian results for innocent, tuition-dependent schools and colleges. A legislative solution is the most effective way of resolving the problem. See e.g., Religious Liberty and Charity Donation Protection Act, 1998, Pub. L.No. 105-183 (1998) (amended 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...”).

*Authored by Michael L. Cook.*

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

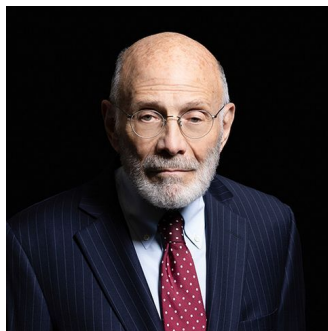
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**Michael  
Cook**

Of Counsel

New York

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