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First Circuit Decision Validates College Tuition Clawback in Bankruptcy

On November 12, 2019, the United States Court of Appeals for the First Circuit reversed a decision of the Bankruptcy Court for the District of Massachusetts in a case that illustrates fraudulent transfer risk for colleges and universities that receive tuition payments from a student's insolvent parents.

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Constructive Fraudulent Transfer Claims and College Tuition Payments

The Bankruptcy Code empowers bankruptcy trustees to avoid certain “constructively fraudulent” transfers made when an insolvent debtor receives less than reasonably equivalent value in exchange for transfers of cash or other assets. In recent years, chapter 7 bankruptcy trustees have brought fraudulent transfer actions against colleges and universities to recover tuition payments made by insolvent parents on behalf of their adult children. Some bankruptcy courts have entered judgments against colleges for constructive fraudulent transfers, while others have held that a parents tuition payments for the undergraduate education of adult children are not constructive fraudulent transfers. In all of these cases, a key question that courts have confronted is whether a debtor/parent receives reasonably equivalent value in exchange for funding tuition payments for an adult child.

First Circuit Finds Parents Received No Value in Exchange for Tuition Payments

In *In re Palladino*, No. 17-1334 (1st Cir. Nov. 11, 2019), a First Circuit appellate panel held that parents do not receive “reasonably equivalent value” when they make tuition payments to a college or university on behalf of an adult child. The court noted that the Bankruptcy Code recognizes five classes of transactions that confer value: (1) the exchange of property, (2) the satisfaction of a present debt, (3) the satisfaction of an antecedent debt, (4) the securing or collateralizing of a present debt, and (5) the granting of security for the purposes of securing antecedent debt. While the *Palladino* Court recognized that a parent's funding of a child's tuition might be a worthy cause and an appropriate expenditure for a solvent person, the payments depleted the estate and afforded no direct value to creditors. The court found that funding an adult child's tuition payments, even with an expectation of future financial support, does not satisfy requirements for a “reasonably equivalent value” defense under the Bankruptcy Code. Additionally, the court noted that the debtors were not under any legal obligation to pay college tuition for their adult children, suggesting in a footnote that the outcome may be different in the case of tuition payments for a minor child. In so holding, the First Circuit has validated tuition clawback lawsuits against colleges and universities.

Implications & Defenses

The *Palladino* decision is the first U.S. Court of Appeals decision to consider whether colleges and universities can be compelled to refund tuition paid by insolvent parents for the education of their adult children. The decision will encourage chapter 7 bankruptcy trustees to seek clawback of tuition payments.

Colleges and universities can specify terms on which parents pay tuition to create an effective defense to tuition clawback lawsuits. If tuition paid by parents is funded into an account that is under the student's control, the student rather than the college or university is the initial recipient of the transfer. The college or university may withdraw funds from the account when tuition is due, but it would be a subsequent transferee. Bankruptcy Code section 550(b) provides a defense to clawback recovery from a subsequent transferee – if the transferee took for value, in good faith, and without knowledge of the voidability of the transfer. A college or university would in most, if not all, cases satisfy these requirements and be considered a good faith transferee. Section 550(b), therefore, can be an effective defense to tuition clawback lawsuits. In the recent case of *In re Hamadi*, 597 B.R. 67 (Bankr. D. Conn. Jan. 31, 2019), the University of

Connecticut successfully defended against a clawback of tuition paid to it by the insolvent parent of one of its students under such a theory.

For more information regarding these recent decisions, or to discuss strategies for structuring tuition payments from parents to minimize fraudulent transfer litigation risk, please feel free to contact [Peter Erichsen](#), the Chair of our [Colleges and Universities](#) practice or [Jim Wilton](#) from our [Business Restructuring](#) practice or your usual Ropes & Gray advisor.