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Feature

By Michelle G. Novick and William A. Williams

Tuition PLUS Loan Proceeds

Do They Withstand Fraudulent Transfer Analysis?

Michelle G. Novick
Arnstein & Lehr, LLP
Chicago

William A. Williams
Arnstein & Lehr, LLP
Chicago

Michelle Novick is a partner and Bill Williams is an associate with Arnstein & Lehr, LLP in Chicago.

While most Americans are worrying about the skyrocketing cost of higher education, bankruptcy trustees are licking their chops. Emboldened by recent decisions characterizing tuition payments made by insolvent parents as constructively fraudulent transfers, trustees across the nation are targeting colleges and universities with clawback suits. This emerging trend has generated considerable attention among higher education and insolvency professionals alike. However, while reported cases to date have all involved direct payments from the debtor/parent, trustees are also suing colleges and universities to recover tuition payments disbursed from the U.S. Department of Education (DOE) through the federal Parent Loan for Undergraduate Students (PLUS) Loan program. This article sets forth important legal and policy bases for disallowing the avoidance and recovery of PLUS Loan proceeds from recipient colleges and universities under 11 U.S.C. §§ 544, 548 and 550.

Mechanics of the PLUS Loan Program

The PLUS Loan program allows parents to borrow money from the DOE to fund their child's college education. The program was created in 1980 "to encourage parents to more directly bear educational expenses rather than transferring that burden to their children through student borrowing."[1] Here is how it works.

The parent submits a PLUS Loan application to the DOE. Once approved, the parent executes a master promissory note (MPN) governing the terms of the transaction. The MPN explicitly forbids the loan proceeds from being used for anything other than the student's educational expenses.[2] The DOE then disburses the loan proceeds directly to the school, and the school credits the student's account for tuition, housing and other authorized charges. The parent can request a new disbursement each semester; all such disbursements are governed by the MPN. While there is no explicit numerical cap, parents cannot borrow more than their child's cost of attendance, which is determined separately by each school. Parent borrowers make payments on PLUS Loans directly to the federal government — there are no direct payments from the parent to the school. The structure of the PLUS Loan transaction provides a strong basis for distinguishing PLUS Loan disbursements from payments received directly from the parent/debtor.

It Is Not the Debtor's Property

The PLUS Loan proceeds are therefore technically not "property of the debtor." Whether suing under § 544 or 548, trustees can only avoid transfers of the debtor's property.[3] In determining whether transferred property is "property of the debtor," the fundamental inquiry is whether the property would have been part of the debtor's estate had the transfer not occurred.[4] Courts must therefore consider whether the debtor has a legal or equitable interest in the property,[5] and whether the property is of the type that would be specifically excluded from the debtor's estate.[6] In the tuition clawback context, litigation typically focuses on the first issue.[7]

To determine whether the debtor has a legal or equitable interest in loan proceeds, the touchstone issue is the degree of control that the debtor exercises over the funds.[8] If the debtor lacks control over the transferred funds, the transfer does not

1 *See* H.R. Rep. 96-520, 29 1980 U.S.C.C.A.N. 3141, 3169 (report of the Committee on Education and Labor) (Oct. 17, 1979).
2 This restriction is further embodied in 20 U.S.C. § 1087e(j).
3 11 U.S.C. §§ 544(a) and 548(a)(1).
4 *Begier v. Internal Revenue Serv.*, 496 U.S. 53, 58-59 (1990).
5 *See* 11 U.S.C. § 541(a)(1).
6 *See* 11 U.S.C. § 541(b).
7 However, § 541(b)(6) may apply if tuition is paid out of a qualified tuition plan governed by § 529 of the Internal Revenue Code. *See* 11 U.S.C. § 541(b)(6); *In re Dunston*, 2017 WL 435801 (Bankr. S.D. Ga. 2017).
8 *In re Wells*, 561 F.3d 633, 635 (6th Cir. 2009) (citing *In re Montgomery*, 983 F.3d 1389, 1393-94 (6th Cir. 1993)); *see also In re Smith*, 966 F.2d 1527, 1531 (7th Cir. 1992).

diminish the estate because the money could never have been used to pay creditors. Although more commonly applied in preference cases, the control test is equally applicable to fraudulent transfers.[9] For example, in *In re Moses*, the debtor took out a bank loan to pay off an antecedent debt just before filing for bankruptcy.[10]

When the chapter 7 trustee attacked the transaction as a preference under § 547, the recipient bank argued that the funds would never have been available for distribution to general creditors as they were specifically earmarked to repay the prior debt.[11] Although the debtor represented to the lending bank that the proceeds would be used to consolidate his debts, the court found that the debtor ultimately retained discretionary control over the funds.[12] Specifically, the court focused on the fact that the loan proceeds were disbursed by a check payable to the debtor rather than to the recipient bank; nothing in the promissory note required the funds to be used to repay the prior debt.[13]

Applying the control test to PLUS Loan transactions, PLUS Loan proceeds should not be characterized as property of the debtor. PLUS Loan proceeds are disbursed directly from the DOE to the school. At no point are the parents/debtors even capable of appropriating the funds for their own use. In addition, both the MPN and the Higher Education Act of 1965 expressly prohibit the funds from being used for any purpose other than the student's reasonable educational expenses. Since the debtor/parent cannot control the use or disposition of the funds, the debtor's estate is not diminished by the disbursement of the PLUS Loan proceeds to the school because the funds could never have been used to pay general creditors. As such, PLUS Loan proceeds should not be characterized as "property of the debtor" and should not be subject to avoidance under § 544 or 548.

It Is Not Even a Transfer

Going one step further, the PLUS Loan transaction should not be characterized as a "transfer" at all but rather as an "incurred obligation." Sections 544 and 548 each authorize trustees to avoid both fraudulent transfers and fraudulently incurred obligations.[14] Although frequently constituting two sides of the same coin, Congress clearly viewed the two transactions as distinct when it crafted the Bankruptcy Code.[15] Whether a transaction is characterized as a transfer or incurred obligation can have significant consequences.

Section 550 only allows trustees to recover on account of avoided transfers, not avoided obligations.[16] This makes sense insofar as when a transfer is made, the recipient actually receives something of value capable of being returned. By contrast, when an obligation is incurred, the obligee only receives a right to future payment. Since avoidance itself rescinds the right to future payment, there is nothing further for the trustee to recover under § 550.

In common parlance, one typically thinks of "transfers" as actual payments and "obligations" as duties to pay in the future. In two-party transactions, the intuitive understanding of these terms seems adequate. Where there are only two parties, an outright payment of value is clearly a transfer, and allowing the trustee to recover the transferred property makes sense. Similarly, one party's incurrence of a duty to pay the other party is clearly an obligation, and cancelling the duty to pay without allowing the trustee to recover from the obligee makes sense. In both cases, the trustee obtains a single satisfaction of the claim.[17]

However, in cases involving more than two parties, relying on such one-dimensional concepts of these terms leads to outcomes that conflict with § 550(d)'s single-satisfaction rule. For example, in the PLUS Loan context, allowing the trustee to recover the tuition payment not only cancels the debtor's duty to pay the DOE, it also gives the debtor's estate an additional windfall at the expense of the innocent university.

A solution to this problem is embodied in the *Allegheny Health* case.[18] In *Allegheny Health*, the debtor assumed the liabilities of another company as part of a merger transaction.[19] When the chapter 11 trustee attacked the transaction as a fraudulently incurred obligation, the defendant moved to dismiss the complaint on the grounds that § 550 does not permit recovery on account of avoided obligations.[20] Recognizing that the debtor's assumption of the defendant's debt conferred a discrete benefit on the defendant, the court recast the transaction as an avoidable transfer and allowed the trustee to proceed on its claims under § 550.[21] Significantly, the court held that notwithstanding how trustees plead avoidance complaints, courts may use their equitable powers to recast transfers as incurred obligations (or vice versa) to expose the true nature of the transaction.[22]

Distilling the *Allegheny Health* holding into a reproducible framework, whether a transaction is properly characterized as a transfer or an incurred obligation turns on how the transaction affects the rights and obligations of the parties involved. Assuming that the transaction diminished the debtor's estate, the next step is to determine whether the net effect of the transaction benefited the defendant by increasing their rights/assets or decreasing their duties/liabilities. If so, the transaction is best characterized as a transfer with respect to that defendant.

However, if the net effect on the defendant is neutral (*i.e.*, any new right/payment received from the debtor is offset by a new obligation/outlay to a third party), the transaction is best characterized as an incurred obligation, and the trustee should not be permitted to recover against the defendant under § 550. This framework advances the principle embodied in § 550 that recovery should only be available against parties who actually received value to the detriment of the debtor's creditors.

9 *See In re Chase & Sanborn Corp.*, 813 F.2d 1177, 1181 (11th Cir. 1987).
10 *In re Moses*, 256 B.R. 641, 643 (B.A.P. 10th Cir. 2000).
11 *Id.* at 645.
12 *Id.* at 643 ("The note signed by the debtor ... did not require that he pay the Bank Loan.").
13 *Id.* at 650.
14 11 U.S.C. §§ 544(a)-(b) and 548(a)(1).
15 *See In re MacMenamin's Grill Ltd.*, 450 B.R. 414, 429 (Bankr. S.D.N.Y. 2011) ("There is clearly a difference between making a transfer and incurring an obligation; otherwise, the relevant statutory provisions would not have used both terms.").
16 *See* 11 U.S.C. § 550 ("[T]he trustee may recover, for the benefit of the estate, property transferred, or ... the value of such property."); *see also U.S. Bank Nat. Ass'n v. Verizon Commc'ns Inc.*, 2012 WL 3100778, at *4 (Bankr. N.D. Tex. 2012); *In re Asia Global Crossing Ltd.*, 333 B.R. 199, 202 (Bankr. S.D.N.Y. 2005); and *MacMenamin's Grill Ltd.*, 450 B.R. at 429.
17 *See* 11 U.S.C. § 550(d) (limiting trustee to single satisfaction).
18 *In re Allegheny Health, Educ. & Research Found.*, 253 B.R. 157 (Bankr. W.D. Pa. 2000).
19 *Id.* at 161.
20 *Id.* at 163.
21 *Id.* at 173-74.
22 *Id.* at 167 n.5.

Applying this framework in the tuition-clawback context demonstrates why PLUS Loan proceeds should not be prone to recovery from recipient colleges and universities. As shown on the left side of the diagram, prior to the PLUS Loan transaction, the rights and obligations of the relevant parties are as follows: (1) the student has a duty to pay the school; (2) the school has a right to payment from the student; and (3) the parent and the DOE have no relevant rights or obligations. Looking on the right side of the diagram, now consider how the PLUS Loan transaction alters these rights and obligations: (1) the parent incurs a duty to pay the DOE; (2) the DOE receives a right to payment from the parent, but also incurs a duty to pay the school; (3) the school receives a right to payment from the DOE, but also loses its right to payment from the student; and (4) the student no longer has a duty to pay the school.

The PLUS Loan transaction leaves the parent/debtor worse off, since the parent incurs a new duty to pay the DOE.[23] The transaction's impact on the school is neutral, since the school's right to payment from the DOE simply replaces the school's right to payment from the student. Similarly, the transaction's impact on the DOE is neutral because the DOE's right to payment from the parent is offset by its duty to pay the school. By contrast, the PLUS Loan transaction leaves the student better off by relieving his/her duty to pay tuition.

Thus, under the *Allegheny Health* framework, the transaction should be characterized as a "transfer" with respect to the student, but as an "incurred obligation" with respect to the DOE. This allows the trustee to recover the value of the transaction from the student — the ultimate beneficiary — without prejudicing the innocent DOE. Furthermore, the trustee has no remedy at all against the school, because the debtor's obligation is to the DOE, not the school.

Policy Considerations

Finally, there are important policy reasons for barring trustees from recovering from colleges and universities in tuition clawback cases. Most significantly, if these cases are not curbed, universities will be forced to offset broader avoidance exposure by raising tuition even higher. In turn, greater numbers of parents will be forced to seek bankruptcy relief after struggling to finance their children's education.[24] At the same time, as the potential recoveries grow, tuition clawback suits will become increasingly appealing to trustees. As this vicious cycle progresses, soaring tuition will jeopardize the feasibility of federal student loans altogether and severely restrict access to higher education.

In short, this technical bankruptcy issue could have wide-ranging consequences on higher education in America. However, by evaluating PLUS Loan transactions in accordance with the principles discussed herein, courts can safeguard educational opportunity, achieve the fairest possible outcomes, and advance the overarching purposes of the trustee's strong-arm powers. abi

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23 Admittedly, courts disagree on whether securing an education for one's child constitutes reasonably equivalent value for tuition payments. *Compare In re Dunston*, 2017 WL 435801 (Bankr. S.D. Ga. 2017); *In re Lindsay*, 2010 WL 1780065, at *9 (Bankr. S.D.N.Y. 2010); and *In re Leonard*, 454 B.R. 444, 457 (Bankr. E.D. Mich. 2011); *with In re Palladino*, 556 B.R. 10, 16 (Bankr. D. Mass. 2016); *In re Oberdick*, 490 B.R. 687, 711-12 (Bankr. W.D. Pa. 2013); and *In re Cohen*, 2012 WL 5360956, at *10 (Bankr. W.D. Pa. 2012).

24 *See* "Haunted by Student Debt Past Age 50," *N.Y. Times*, Feb. 13, 2017, *available at* nytimes.com/2017/02/13/opinion/haunted-by-student-debt-past-age-50.html ("Americans age 60 and older are the fastest-growing age group of student loan debtors.").

Diagram