BANKRUPTCY'S EVOLVING IMPACT ON HIGHER EDUCATION

Student Loan Dischargeability and Tuition Claw Back

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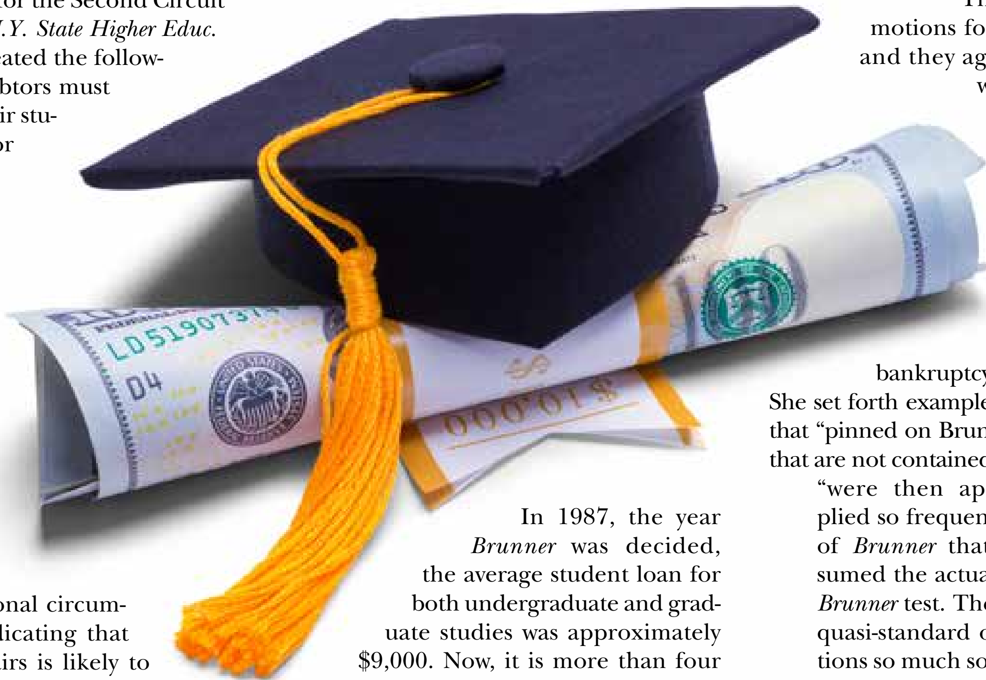
STUDENT LOAN DISCHARGEABILITY

The U.S. Bankruptcy Code provides that students loans are not dischargeable in bankruptcy cases unless not discharging the student loans "would impose an undue hardship on the debtor and the debtor's dependents" 11 U.S.C. § 523(a)(8). In 1987, the Court of Appeals for the Second Circuit decided *Brunner v. N.Y. State Higher Educ. Servs. Corp.*, which created the following high standard debtors must meet to discharge their student loans in whole or in part:

1. "That the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for herself and her dependents if forced to repay the loans;
2. That additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
3. That the debtor has made good faith efforts to repay the loans."



Some bankruptcy courts—before and after *Brunner*—seemed to make the test even more difficult, with some requiring proof of "certainty of hopelessness" to discharge student debts and others concluding a debtor's mere attempt to discharge student loan debt constituted bad faith. Eventually, consumer bankruptcy attorneys were discouraged from attempting to discharge any student loans other than those incurred by borrowers with the most severe disabilities. Perhaps not surprisingly, of the approximately 250,000 student loan borrowers who file for bankruptcy each year, only about 400—or .0016 percent—seek to discharge their student loans.[1]

In 1987, the year *Brunner* was decided, the average student loan for both undergraduate and graduate studies was approximately $9,000. Now, it is more than four times that, with many students obtaining higher education loans that collectively exceed six figures. Given *Brunner* and its progeny, what should a debtor do when his monthly expenses exceed his monthly income, he owes more than $200,000 in college and law school loans, he left his first job out of law school after less than three months, and, 25 years since taking out his first student loan, he works as a hiking and camping guide earning $37,500 annually?

On March 12, 2018, that debtor, Kevin Rosenberg, filed a *pro se* chapter 7 bankruptcy case in the U.S. Bankruptcy Court for the Southern District of New York. Rosenberg's bankruptcy schedules disclosed his substantial student loan debt. Without a lawyer, Rosenberg sued the holders of his student loan promissory notes, seeking the court's declaration that his entire student loan debt was dischargeable as an "undue hardship" under section 523(a)(8) of the Bankruptcy Code.

The parties filed cross motions for summary judgment, and they agreed the *Brunner* test was the correct test for the court to apply. In her written decision on the matter, Chief Judge Morris noted that "*Brunner* has received a lot of criticism for creating too high of a burden for most bankruptcy petitioners to meet." She set forth examples of bankruptcy courts that "pinned on Brunner punitive standards that are not contained therein" and which

> "were then applied and reapplied so frequently in the context of *Brunner* that they have subsumed the actual language of the *Brunner* test. They have become a quasi-standard of mythic proportions so much so that most people (bankruptcy professionals as well as lay individuals) believe it impossible to discharge student loans … The court will not participate in perpetuating these myths."

Judge Morris then proceeded to "apply the *Brunner* test as it was originally intended."

After finding that Rosenberg's current expenses exceeded his current income by more than $1,500, his student loan debt totaled $221,385.49, and he was not eligible for a repayment plan, the court concluded the first prong of the *Brunner* test was met. The second prong—that this state of affairs was likely to persist for a significant portion

of the repayment period—was deemed satisfied because the court determined the repayment period under the student loans had already ended. Judge Morris also decided that Rosenberg's loan repayment history and instances of taking positive initiative in communicating and working with the student loan lenders were sufficient to satisfy the test's third prong. Consumer bankruptcy attorneys have described Judge Morris' opinion in the *Rosenberg* case as a watershed moment for the dischargeability of student loans in bankruptcy. A motion for leave to appeal the decision has been filed.

Will directly challenging the manner in which many bankruptcy courts have applied the decades-old rule in *Brunner* result in a change in practice for the bankruptcy bench and bar? It is not a stretch to expect more potential debtors and their bankruptcy counsel to expend the necessary time, money, and effort in exchange for a potentially improved chance to discharge significant student loan debt. Will other bankruptcy judges, none of whom are bound to follow Judge Morris' ruling, nevertheless be persuaded by her analysis until the appellate process in this adversary proceeding is complete?

In addition to questions regarding the dischargeability of loans that were incurred to pay higher education tuition, there are separate questions regarding whether and when tuition payments received by an institution of higher education can be recovered as a fraudulent transfer by the bankruptcy trustee in the parents' bankruptcy case. As more bankruptcy trustees have filed lawsuits to recover tuition payments after parents of adult students file for bankruptcy, some answers have begun to materialize.

TUITION CLAW BACK

In 2012, the Palladinos' 18-year-old adult daughter enrolled as an undergraduate at Sacred Heart University in Fairfield, Connecticut. Between March 2012 and March 2014, the Palladinos paid $64,656.22 in tuition to the university. In April 2014, the Palladinos filed a chapter 7 bankruptcy petition in the U.S. Bankruptcy Court for the District of Massachusetts.[2]

In July 2015, the chapter 7 trustee sued Sacred Heart to claw back the tuition payments from the Palladinos to the university. The trustee's best claim was under Section 548(a)(1)(B)(i) of the Bankruptcy Code, which allowed the trustee to avoid any debtor transfers made in the two years before the bankruptcy filing in exchange for which the debtor received less than reasonably equivalent value. The trustee's counsel argued that reasonably equivalent value was lacking because the tuition payments reduced the Palladinos' estate by almost $65,000 without a concomitant tangible increase in value. The Palladinos' counsel argued the daughter's tuition provided substantial value because the Palladinos "believed that a financially self-sufficient daughter offered them an economic benefit."

Faced with these facts and because courts in tuition claw back cases interpreted reasonably equivalent value differently, the bankruptcy court determined the value received by the Palladinos in helping secure their daughter's college education was reasonably equivalent value for the tuition payments. The bankruptcy court then, on its own, certified its decision to the U.S. Court of Appeals for the First Circuit.

On November 12, 2019, the First Circuit issued its written decision. Referring to the answer as "straightforward," though noting one might argue for a different outcome in the case of a minor child, it concluded that "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." The First Circuit reversed and remanded the bankruptcy court's decision.

Palladino closed the door in the First Circuit on arguments by colleges and universities regarding "indirect" value received by parents who pay tuition for their adult children. Bankruptcy courts in Massachusetts, New Hampshire, Puerto Rico, and Rhode Island are bound to follow the *Palladino* decision, and other bankruptcy courts around the country will certainly consider it when faced with similar issues.

All is not lost for higher education, however, as there are other ways to defeat tuition claw back claims in the right instances. For example, in *Novak v. University of Miami (In re Demitrus)*, a Connecticut bankruptcy case before Judge James Tancredi, the trustee sued the University of Miami to claw back approximately $66,000 in parent tuition payments using the same arguments as the trustee in *Palladino*.[3] In that case, however, the university moved to dismiss the lawsuit because the tuition payments at issue were made via a Parent PLUS loan in which the tuition payments were made directly from the Department of Education to the university without the parents ever gaining possession, custody, or control of the tuition funds.

In dismissing the trustee's lawsuit against the university, Judge Tancredi stated that "the clear consensus forming in the courts on this issue is reflective of the purpose underlying the trustee's avoidance powers, namely, to prevent the depletion of assets that otherwise would have been available to creditors." He determined the funds paid to the university could not possibly have been the parents' property or reached by the parents' creditors and, as a result, dismissed the trustee's tuition claw back lawsuit. Whereas depleting the parent/debtor's bankruptcy estate benefited the trustee's arguments in *Palladino*, the absence of depleting the estate derailed the trustee's claims against the University of Miami.

Schools have also avoided tuition payment claw back in cases where the student has access to the tuition funds provided by the parents as well as the institution. In another case before Judge Tancredi—*Mangan v. University of Connecticut (In re Hamadi)*—refundable tuition payments were made by the parents into an account maintained by the University of Connecticut. Afterwards, the parents filed a bankruptcy case in Hartford, Connecticut. Relying on an increasing amount of bankruptcy court precedent, Judge Tancredi determined the refundable tuition funds belonged to the student because the university did not have the immediate right to use the funds for its own purposes. Treating the student as the first recipient of the tuition funds and the university as a subsequent recipient (once the tuition funds became nonrefundable) opened up a potential good-faith defense under the Bankruptcy Code, which helps higher education defendants bypass tuition claw back liability.

Litigation and precedent involving tuition claw back cases will continue to evolve, and lawsuits based on diminution to the estate will continue to expand into new areas.

Ilan Markus of Barclay Damon LLP handles bankruptcy and other types of insolvency matters, representing debtors, creditors, secured lenders, landlords, equipment lessors, creditors' committees, trustees, assignees for the benefit of creditors, and purchasers. Specifically, Ilan routinely represents financial institutions, biomedical companies, managed services providers, telecommunications companies, health care providers, tenants, retailers, and hotels.

1 Debra Weiss, *Law Grad Wins Discharge of His Student Debt in Opinion Criticizing 'Punitive Standards,'* ABA J., Jan. 9, 2020 (citing research by Jason Iuliano, assistant professor of law at Villanova University).

2 In January 2014, the Palladinos pled guilty in state court to fraud in connection with operating a multi-million-dollar Ponzi scheme.

3 The author defended the University of Miami in that tuition claw back lawsuit.