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AVOIDING TUITION PAYMENTS AS FRAUDULENT CONVEYANCES UNDER THE UNIFORM FRAUDULENT TRANSFER ACT AND THE BANKRUPTCY CODE

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I. INTRODUCTION:

Under the Bankruptcy Code and the laws of most states, a fraudulent conveyance arises when a debtor, voluntarily or involuntarily, transfers an interest in property, or incurs an obligation either (A) with the actual intent to hinder, delay or defraud creditors; or (B) receives less than reasonably equivalent value in exchange for such transfer or obligation and (i) was insolvent on the date that such transfer was made or such obligation was incurred, or become insolvent as a result of such transfer or obligation, (ii) was engaged in business for which the remaining property of the debtor was unreasonably small capital, or (iii) intended to incur, or believed that it would incur debts beyond the debtor's ability to pay as such debts matured.

In bankruptcy, fraudulent conveyances are avoidable pursuant to Sections 544 and 548 of the Bankruptcy Code.[1] Section 548 of the Bankruptcy Code is the federal encapsulation of the Uniform Fraudulent Transfer Act (the "UFTA"). Section 544(b)(1) of the Bankruptcy Code gives the trustee the rights of an unsecured creditor to avoid "any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law." Applicable law includes various state fraudulent conveyance statutes such as the UFTA.[2]

This paper discusses the current split among courts as to whether pre-petition school tuition payments can be avoided as fraudulent conveyances. This issue has various permutations and can involve tuition for pre-secondary private schooling when a public education is available, or tuition for college when the student is over the age of 18. While avoidance actions have arisen under theories of actual fraud or unjust enrichment, the issue typically arises under a constructive fraud theory, with the question being whether the debtor received reasonably equivalent value for the tuition payments made. Questions also arise under Section 550 of the Bankruptcy Code as to whether the school is an initial transferee or an immediate or mediate transferee.

II. REASONABLY EQUIVALENT VALUE - A SUMMARY:

The term "reasonably equivalent value" is not defined in the Bankruptcy Code or the UFTA. Rather, Section 548(d)(2)(A) of the Bankruptcy Code simply defines "value" as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."[3] The same definition is utilized in the UFTA. Simplistically, the determination of whether reasonably equivalent value was received by the debtor involves a comparison of what was given with what was garnered in return. *In re Guerrera,* 225 B.R. 32, 36 (Bankr.D.Conn.1998). Courts consider such factors as: (1) whether the value of what was transferred is equal to the value of what was received; (2) the market value of what was transferred and received; (3) whether the transaction took place at arm's length; and (4) the good faith of the transferee. *In re 4100 W. Grand LLC*, 481 B.R. 444, 454-55 (Bankr.N.D.Ill.2012).[4]

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1 11 U.S.C. §§ 544 & 548.

2 740 ILCS §5/160 *et seq.*

3 See, 11 U.S.C. § 548(d)(2)(A).

4 In *In re LaForte*, 2017 WL 1240198 (Bankr.E.D.N.Y. March 31, 2017), the court determining whether "fair consideration" was provided pursuant to the New York Debtor & Creditor Law, Section 272, stated that fair

Further, the question is typically determined by the value of the consideration exchanged between the parties at the time of the challenged conveyance or incurrence of the debt. *In re Next Wave Personal Communications,* 200 F.3d 43 (2nd Cir.1999).[5] Neither "mathematical precision" nor a "penny-for-penny" exchange is necessary in order to establish reasonably equivalent value. See, *In re Guerrera,* 225 B.R. at 36, and *Barber v. Golden Seed Co., Inc.*, 129 F.3d 382, 387 (7th Cir.1997) (There is no fixed mathematical formula for determining reasonably equivalent value.) In *In re Rosich,* 570 B.R. 278 (Bankr.W.D.Mich.2017), the court also noted that reasonably equivalent value is not viewed from the debtor's perspective of what was given up, but from the creditors' perspective, comparing what they lost because of the debtor's transfer and what, if anything, they gained as a result. *Id.* at 281. In other words, courts ask the common-sense question: did the transfer harm the creditors?

In re Bowers-Siemon Chemical Co., 139 B.R. 436 (Bankr.N.D.Ill.1992) stands for the proposition that the value needed to support a transfer can be indirect, *i.e.*, a benefit flowing to the debtor from a direct benefit paid to a third party. A similar conclusion was reached *In re Richards & Conover Steel Co.,* 267 B.R. 602 (8th Cir.BAP 2001). In that case, the court quoting from *2* David G. Epstein, BANKRUPTCY §6-49, at 23 (1992) stated, "[t]he requirement of economic benefit to the debtor does not demand consideration that replaces the transferred property with something else tangible or leviable that can be said to satisfy the creditor's claims." Rather, in deciding whether value has been transferred, one must examine all aspects of the transaction and carefully measure the value of all benefits and burdens to the debtor, direct or indirect.[6]

III. PRIVATE PRE-SECONDARY SCHOOL TUITION:

A number of courts have dealt with the issue of whether private pre-secondary school tuition payments can be avoided as constructively fraudulent conveyances. In *In re Michel,* 573 B.R. 46 (Bankr.E.D.N.Y.2017), the trustee commenced an adversary proceeding against the Trey Whitfield School by filing a complaint to avoid and recover tuition payments that the debtor made to the school for the school years beginning in 2011, 2012, and 2013. The trustee claimed that he could avoid and recover the tuition payments as constructive and intentional fraudulent transfers under Sections 548 and 550 of the Bankruptcy Code and New York Debtor and Creditor Law Sections 273, 274, 275, 276, and 278, and under a common law theory of unjust enrichment. In this case, the debtor made tuition payments totaling $15,385 for her minor children's education.

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consideration (the functional equivalent of reasonably equivalent value) is given when three criteria are met: (1) in exchange for the debtor's property, the recipient either conveys property or discharges an antecedent debt; (2) the debtor receives the "fair equivalent" of the property conveyed; and (3) the exchange is undertaken in good faith. *Id.* at *5.

5 Generally, an obligation is incurred when a debtor becomes legally obligated to pay. *Barash v. Public Finance Corp.,* 658 F.2d 504, 511 (7th Cir.1981).

6 In *In re Mongelluzzi*, 587 B.R. 392, 403 (Bankr.M.D.Fla.2018), the court noted that the Eleventh Circuit in *In re Rodriguez*, 895 F.2d 725, 727 (11th Cir.1880) recognized that an indirect benefit may constitute reasonably equivalent value if an economic benefit was conferred upon the debtor. The logic is that reasonably equivalent value is to protect creditors against the depletion of a bankruptcy estate. This purpose is served if the debtor receives an economic benefit that preserves the debtor's net worth and, as a result, the interests of its creditors are not injured by the transfer. *Id.* at 405.

The court dismissed the action, noting that the parents received reasonably equivalent value for the tuition payments and, thus, the transfers were not constructively fraudulent. In doing so, it stated that "it is axiomatic that parents are obligated to provide for their children's necessities, such as food, clothing, shelter, medical care, and education." *Id.* at 60 (citing to *Geltzer v. Xaverian High School (In re Akanmu)*, 502 B.R. 124, 132 (BankrE.D.N.Y.2013)). A parent's failure to observe minimum standards of care in performing these duties can result in both remedial sanctions, such as the forfeiture of custody, and criminal sanctions. Therefore, it was implausible to suggest that a parent does not receive some value in exchange for tuition payments in connection with meeting these obligations. *Id.*

The court went on to note that parents are not required to acquire goods or services at the lowest cost, or no cost at all, before his or her bankruptcy case is filed:

> It is irrelevant to this determination whether the Debtors could have spent less on the children's education, or, for that matter, on their clothing, food or shelter. 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. * * * * The absurdity of this scenario is obvious.[7]

In response to the trustee's argument that the "reasonably equivalent value" standard calls for the court to assess the presence or absence of concrete economic benefits to the transferor at the time of the transfer, the court quoted from *Balaber–Strauss v. Sixty–Five Brokers (In re Churchill Mortg. Inv. Corp.)*, 256 B.R. 664, 681 (Bankr.S.D.N.Y.2000) (quoting *Martino v. Edison Worldwide Capital* (*In re Randy)*, 189 B.R. 425, 441 (Bankr.N.D.Ill.1995)), *aff'd sub nom. Balaber–Strauss v. Lawrence*, 264 B.R. 303 (S.D.N.Y.2001) as follows:

> Often, a debtor prior to bankruptcy will make improvident purchases or expenditures which have a detrimental effect on creditors and may even be the precipitating cause of bankruptcy. A spendthrift debtor may purchase clothes or a new car, take costly vacations on credit, or otherwise incur unpayable debts for goods or services. The fact that all these transactions may be said to "exacerbate the harm to creditors and diminish the debtor's estate" from an overall perspective does not mean that the debtor received less than reasonably equivalent value in respect of each particular transaction.[8]

The court also noted that educational services provided to minor children "may constitute consideration to the parents" because of the confluence of economic interests among a family unit of minor children and their parents." Therefore, goods and services purchased by parents for their minor children should be treated, for purposes of a constructive fraudulent conveyance analysis, as though they had been purchased by the parents for themselves." In making this statement, *Michel* espouses the "single economic unit" theory by which the debtor and her minor children are viewed as a singular unit. The court noted that it was simply not part of a Chapter 7

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[7] *Id.* at 60 (quoting to *Xaverian*, 502 B.R. at 132).
[8] *Id.* at 60-61.

trustee's portfolio of duties to exercise a "veto power over a debtor's personal decisions, at least with respect to pre-petition expenditures." *Id.* at 61.

A similar conclusion was reached in *In re Karolak,* 2013 WL 4786861 (Bankr.E.D.Mich. Sept. 6, 2013). Here, the debtor was a teacher at University Liggett School. As an employment benefit, the debtor was eligible to send her minor children to school at Liggett and pay a reduced amount for their tuition. During the years 2010, 2011 and 2012, the debtor sent her three minor children to school at Liggett and paid for their tuition by a regular deduction from her paycheck.

The court concluded that the debtor received reasonably equivalent value in exchange for the tuition payments, which value consisted of the grammar school education that the children received. *Id.* at *3. The court noted that in Michigan, a parent has a legal obligation under MICH COMP. LAWS ANN. §380.1561(1) to provide schooling for their children. And the fact that the debtor could arguably have provided a cheaper form of education to her children than sending them to Liggett was irrelevant and did not mean that she failed to receive reasonably equivalent value in exchange for the tuition payments. *Id.*

IV. COLLEGE TUITION:

(i) Tuition Payments Avoidable:

In *Banner v. Lindsay (In re Lindsay),* 2010 WL 1780065 (Bankr.S.D.N.Y. May 4, 2010) the court held that college tuition payments were avoidable as constructively fraudulent transfers, concluding that the debtor presented no evidence of a legal obligation to pay his son's college tuition. Without that evidence, the court concluded that "the debtor did not receive fair consideration." *Id.* at * 9-10.

A similar conclusion was reached in *Gold v. Marquette University (In re Leonard),* 454 B.R. 444 (Bankr.E.D.Mich.2011). However, this case contained some unique facts. Here, the debtor's son applied for a student loan, in the amount of $35,000.00. The debtor and his son both signed the promissory note as co-signors. The bank approved the student loan and mailed a check payable to both the debtor and his son. The son endorsed the check and gave it to his mother (who was also a debtor in the subsequent bankruptcy) for deposit into her bank account.

The first argument made in defense of the avoidance action was that the funds were held in trust and, thus, could never have been property of the bankruptcy estate.[9] While there was no actual written trust agreement, the court found that this was not outcome determinative, as under Michigan law, an express trust can be established orally, at least with respect to personal property. However, "[t]o establish a trust of personalty, [the] parol evidence must be clear and satisfactory and find some support in the surrounding circumstances and conduct of the parties." *Id.* at 451. Here, circumstantial evidence existed suggesting no trust existed precluding summary judgment in favor of the school. This evidence included the fact that (i) the check was made payable jointly to the debtor and his son, (ii) the check was deposited in a joint account in which

[9] The Sixth Circuit has held that when a debtor holds property in trust for another, and makes a pre-petition transfer of such property, the transfer is not subject to avoidance as a fraudulent transfer under §548. Because the debtor holds only legal title, and not equitable title, to such trust property, the transfer of such property is not a transfer of "an interest of the debtor in property" within the meaning of §548.

the son had no interest and commingled with other funds of the debtor, and (iii) there was evidence that after the funds were deposited in the debtors' joint checking account, the debtors used some of the funds for their own benefit.

The court then considered the issue of whether the debtors received reasonably equivalent value for the tuition payments. The court held that while this "[v]alue can be in the form of either a direct economic benefit or an indirect economic benefit," in the Sixth Circuit where the benefit to the debtor/transferor is indirect, the transferee has the burden of showing that this indirect benefit to the debtor/transferor is "concrete and quantifiable" and, in fact, must quantify that benefit. *Id.* at 456-57. In other words, whether the benefit to a debtor from a transfer is direct or indirect, it must be an "economic" benefit to the debtor in order to be considered "value." The focus should be on the overall effect on the debtor's net worth after the transfer. *Id.* at 457.

> Applying these requirements to this case, it is clear that the Debtors did not receive any "value" for their tuition payments to Marquette, and therefore did not receive "reasonably equivalent value." Marquette points to no economic benefit to the *Debtors,* other than to speculate that a college education for Debtors' son may in the future enable him to be financially independent of his parents, and thereby relieve Debtors of any need to financially support their son. But Marquette does not argue, and cannot demonstrate, that Debtors had or would have any legal obligation to support their adult son, either at the time of the transfers, when Debtors' son was 18 years old, or at any time in the future. And even if Debtors had such a legal obligation, it is nothing but speculation to suggest that Debtors' payment of tuition for their son's first semester of college at Marquette will make a difference between the Debtors needing to assist their son financially in the future and not needing to do so.
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> Understandably, Debtors may have felt a moral obligation to help their son pay for college, which the tuition payments helped satisfy. And Marquette argues that paying Benjamin's first-semester tuition "bestowed peace of mind" on the Debtors that Benjamin "will be afforded opportunities" in life that would not have come but for the education he received at Marquette. While satisfying such a moral obligation and receiving such "peace of mind" may be very real benefits that are personally quite important to the Debtors, these intangible benefits are not "economic" benefits to the Debtors. Nor are they "concrete" and "quantifiable" benefits.[10]

Matter of Dunston, 566 B.R. 624 (Bankr.S.D.Ga.2017) followed this line of cases. The court recognized that the debtor may feel a moral obligation to pay for their child's college education and help her to achieve financial independence. "However, I find that the satisfaction of such moral obligation does not provide an 'economic' benefit to the Debtor. By paying for her daughter's tuition, the Debtor did not discharge or satisfy any legal duty or obligation to do so, nor did she increase her assets in any way that could be used to pay her creditors. Because [no] * * * evidence [was provided] of an "economic" benefit conferred on the Debtor, it is not

10 *Id.*

entitled to summary judgment as to any of the Transfers on the basis that the Debtor received "reasonably equivalent value" in exchange for the Transfers." *Id.* at 637.

In *Chorches v. Catholic University of America,* 2018 WL 3421318 (D.Conn. Aug. 14, 2018)), the student in question was older than 18 and attended Catholic University. The debtors paid Catholic University $64,845.50 for their daughter's tuition between September 2011 and June 2014, $30,659.50 of this amount between September 2013 and June 2014.

The university argued that the complaint failed to allege that the debtors did not receive "reasonably equivalent value" for the tuition payments they made on behalf of their daughter. It argued that parents derive value from the college education of their adult child, because (1) "[i]t is [ ] commonplace among untold millions of American families, and deeply ingrained in our culture, to treat college tuition payments as a family obligation, no less so than mortgage and grocery payments," and (2) "[c]reditors know that, as surely as borrowers will use available funds to pay for the mortgage and groceries, borrowers will pay their children's college expenses to the extent they are willing and able to."

The court disagreed and stated that the university's arguments were inconsistent with the text of the Bankruptcy Code. It noted that though "reasonably equivalent value" is not specifically defined, the statute defines "value" in purely economic terms, *i.e.*, "property, or satisfaction or securing of a present or antecedent debt of the debtor, but * * * not * * * an unperformed promise to furnish support to the debtor or to a relative of the debtor."[11] "Under this definition, the [debtors] did not receive any "value" in exchange for their tuition payments: they did not receive 'property' of any kind, and their tuition payments did not satisfy or secure a 'present or antecedent debt' that *they* (as the debtors) owed, as the [debtors] had no legal obligation to pay college tuition for [their daughter]." *Id.* at *3.

> [D]ischarging a "moral obligation" or meeting a "societal expectation" is not "value" within the meaning of the statute. Congress' treatment of donations to religious organizations in the bankruptcy statute illustrates this. In response to judicial decisions holding that tithes and other donations to religious organizations were not exchanged for "value," Congress enacted the Religious Liberty and Charitable Donation Protection Act. * * * * Congress can likewise provide a specific statutory carve-out for tuition payments for adult children, if it deems appropriate, but it has not done so to date.[12]

The university also tried to argue that the debtors received value in the form of the anticipated economic benefit they will gain in having a financially self-sufficient daughter due to her college education. The court, however, found this rationale unpersuasive, because "the prospect that an adult child would fare better financially, require less financial support, or even later repay the [debtors was] speculative." ***Id.*** Further, the court stated that the notion that paying for an adult child's college education would diminish the need for future parental support payments was itself based on a moral obligation rather than a legal one: "parents are generally not required to support adult children whether or not they attend college and regardless of their

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11 11 U.S.C. §548(d)(2)(A).
12 *Id.*

financial condition." *Id.*

The university also argued that the debtors should be considered a "single economic unit" on the grounds that their daughter was under the age of 24 and, under certain federal laws, still could be considered part of her parents' family. Accordingly, the argument goes, her college tuition was a household expense like any other and, therefore, not avoidable. The court, again, disagreed. It noted that many families either cannot or choose not to cover the expected family contribution and, contrary to the university's implication, there was no legal requirement that parents contribute to college tuition at all. *Id.* at *4. The court further explained:

> In any event, * * * Congress knew how to create exceptions to the background, state-law rule that dependency ends at the age of majority, which it has not done in the fraudulent transfer statute. These narrow carve-outs in other areas of law have no bearing on whether parents and their adult children should be treated as a "single economic unit" for the purposes of whether the Franzeses received "reasonably equivalent value" under the Bankruptcy Code (or Connecticut law) for tuition payments on behalf of their adult daughter.[13]

The court concluded that payment for the education of minor children was distinguishable from payment for adult children's college tuition. "Parents are legally responsible for ensuring that their minor children receive an education, as they are held legally responsible for their children's other needs. * * * * But the same is not true for children 18 or older, who are legally considered adults." *Id.*

In *In re Palladino,* 556 B.R. 10 (Bankr.D.Mass.2016) the bankruptcy court held that debtor parents did receive reasonably equivalent value in exchange for the payment of their adult child's college tuition. In making this ruling, the court stated as follows:

> I find that the [parents] paid [Sacred Heart University] because they believed that a financially self-sufficient daughter offered them an economic benefit and that a college degree would directly contribute to financial self-sufficiency. I find that motivation to be concrete and quantifiable enough. The operative standard used in both the Bankruptcy Code and the UFTA is "reasonably equivalent value." The emphasis should be on "reasonably." Often a parent will not know at the time she pays a bill, whether for herself or for her child, if the medical procedure, the music lesson, or the college fee will turn out to have been "worth it." But future outcome cannot be the standard for determining whether one receives reasonably equivalent value at the time of a payment. A parent can reasonably assume that paying for a child to obtain an undergraduate degree will enhance the financial well-being of the child which in turn will confer an economic benefit on the parent. This, it seems to me, constitutes a *quid pro quo* that is reasonable and reasonable equivalence is all that is required.[14]

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13 *Id.* at *5.

14 *Id.* at 16.

The bankruptcy court then certified its decision for direct appeal to the First Circuit Court of Appeals under 29 U.S.C. §158(d)(2). The circuit court reviewed the ruling and reversed the decision. In doing so, the court noted that because the purpose of fraudulent transfer laws is to preserve the debtor's estate for the benefit of unsecured creditors, courts need to evaluate transfers from the creditors' perspective, measuring value at the time of the transfer. *In re Palladino,* 942 F.3d 55, 59 (1st Cir.2019).

> To us, the answer is straightforward. 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 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 purpose of securing an antecedent debt. None are present here, nor are parents under any legal obligation to pay for college tuition for their adult children.[15]

In explaining its ruling, it stated that it was Congress which enacted the fraudulent and constructively fraudulent claw back laws. "The members of Congress were elected by the public and when they have 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 Bankruptcy Code, that is the end of the matter." *Id.*

(ii) <u>Payment of Tuition Not Avoidable</u>:

In *Shearer v. Oberdick (In re Oberdick),* 490 B.R. 687, 712 (Bankr.W.D.Pa.2013), the court held that funds paid for a child's undergraduate college tuition constituted expenditures for necessities and, therefore, were not avoidable under Pennsylvania's UFTA. A similar conclusion was reached in *In re Fisher,* 575 B.R. 640 (Bankr.M.D.Pa.2017). Here, the trustee filed a complaint which alleged that, within two years of the petition date, the debtor made tuition payments to Pennsylvania State University on behalf of her adult son, which totaled approximately $5,827.72, which he argued were recoverable as fraudulent transfers pursuant to §548. The court determined that the only real issue was whether the debtor received reasonably equivalent value for the tuition payments. In evaluating this issue, the court quoted from *Eisenberg v. Pennsylvania State University (In re Lewis)*, 574 B.R. 536, 541 (Bankr.E.D.Pa.2017), which concluded:

> A parent's payment of a child's undergraduate college expenses is reasonable and necessary expense for maintenance of the family and for preparing family members for the future. The parent therefore receives reasonably equivalent value in exchange for the tuition payment.

The court agreed with *Lewis'* conclusion, but only to a limited extent. It concluded that the debtor received at least some intangible value in exchange for the tuition payments, in that the debtor was now less worried about her son's future economic prospects. However, the court needed more of a record, explaining that there were still unanswered questions. In particular, the

15 *Id.*

court inquired as follows: Has the Debtor's son graduated? If so, in what is his degree? Is he presently employed? If so, what is his position and does it require an undergraduate degree? Is the Debtor currently providing any financial support to her son? *Id.* at 648.

The case of *In re Demitrus,* 586 B.R. 88 (Bankr.D.Conn.2018) dealt with this issue from a slightly different context. In this case, the debtor's son was over the age of 18. While he was a student at the University of Miami, the debtor made a number of transfers to the university by means of a Federal Direct Parent PLUS loan ("Parent PLUS Loan") to pay tuition. The trustee claimed that these payments constituted constructive fraudulent transfers, pursuant to the Bankruptcy Code and the UFTA. He sought that $66,616.00 be avoided and/or set aside and recovered for the benefit of the debtor's estate.

The court dismissed the adversary proceeding. It did so noting that under both state and federal fraudulent conveyance laws, a transfer may only be avoided if, *inter alia*, the transferred funds constituted "an interest of the debtor in property." *Id.* at *2. This leads to the question of whether the Parent PLUS Loan payments constituted property or assets of the Debtor. In this regard, the Direct PLUS Loan program was established for the purpose of allowing eligible parents to pay the tuition of dependent children to go to college. The Parent PLUS Loans could only be issued "to pay for the student's cost of attendance * * * * at "[c]olleges, universities, graduate and professional schools, vocational schools, and proprietary schools.* * * *."[16] The court then quoted two opinions, which dealt with the Parent PLUS Loans in the fraudulent conveyance context. The first decision was the previously cited case of *Lewis*, quoted, in part, as follows:

> [T]he proceeds from the Parent PLUS loans were never [the debtor's] property, were never in his possession or control, and were never remotely available to pay [the debtor's] creditors. As a result, the [DOE's] payment of the Parent PLUS loan proceeds to Penn State did not diminish [the debtor's] bankruptcy estate and avoidance of these transfers would be improper and unwarranted.
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> The Parent PLUS loan proceeds were never in [the debtor's] possession or control, could not ever be in [the debtor's] possession or control, and therefore could not possibly be considered to be property of the estate * * *
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> Permitting the trustee to proceed with this litigation would enable fraudulent transfer avoidance statutes to be used improperly as revenue generating tools. Such usage would do nothing to further the fundamental premise underlying both the Bankruptcy Code and PUFTA fraudulent transfer provisions, which is 'to prevent a debtor from putting assets otherwise available to its creditors out of their reach * * * and to prevent the unjust diminution of the debtor's estate.'

The court then quoted from *Shapiro v. Gideon (In re Gideon)*, Case No. 15–50464, Adv. Pro. No. 16–4939 (TJT) (Bankr.E.D.Mich. Apr. 26, 2017), as follows:

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[16] *See* 34 C.F.R. §685.101(a).

> [T]he evidence is clear and undisputed that at no time did the loan proceeds - did these loan proceeds go into a bank account of the bankruptcy debtor * * * nor did they go in any way through his hands or * * * to his possession. He never had possession of the loan funds.* * * * [S]o it certainly appears from all of that that while the bankruptcy debtor * * * did incur an obligation as * * * the borrower on these PLUS loans and quite arguably incurred an obligation that might be avoidable as a * * * fraudulent obligation because the debtor * * * may not have received reasonably equivalent value for the obligation he incurred on these loans * * * avoidance of the obligation that [the debtor] incurred is not what the trustee seeks in this adversary proceeding. That's clear from the complaint and the argument on * * * this motion. It is, rather, avoidance of the transfer and recovery of the funds–the loan funds–that were transferred from the Department of Education to DePaul under the PLUS loans at issue. Those are the transfers alleged in the trustee's complaint and it's clear the trustee is seeking avoidance of those transfers, and not avoidance of any obligation that the debtor.* * * incurred in connection with those loans * * * [U]nder the undisputed facts, material facts here that are relevant to the issue, the record clearly shows, and there can be no genuine dispute here—that the loan funds at issue that were transferred to DePaul were not property of the debtor * * *

In *In re DeMauro,* 586 B.R. 379 (Bankr.D.Conn.2018), the trustee sought to avoid and recover as constructive fraudulent transfers certain Federal Direct Parent PLUS Loan proceeds disbursed to Johnson & Wales University for the tuition of the debtors' adult daughter pursuant to 11 U.S.C. §§ 544, 548 and 550. Each year the daughter was enrolled at the University, the debtors applied for and were approved by the United States Department of Education ("USDOE") for a Federal Direct PLUS Loan to help subsidize the cost of the daughter's education at the University. In order for the debtors to obtain a Federal Direct PLUS Loan, the USDOE required them to complete and sign a Direct PLUS Loan Master Promissory Note. When the debtors executed the note, they certified under penalty of perjury that the loan proceeds would be used for the daughter's educational expenses, only. The University received the funds for the Payments from the USDOE through a USDOE grant management portal known as "G5".

The court started its analysis by noting that in order to avoid a transfer as a fraudulent under either §§ 544, 548, or CUFTA, the trustee must establish that the debtors held an interest in the Direct PLUS Loan proceeds. *Id.* at 384-85. However, under the Direct PLUS Loan Program, the USDOE provides funds directly to an institution of higher education. In the event an institution receives from the USDOE an amount that "exceeds the amount of assistance for which the student is eligible * * * the institution such student is attending shall withhold and return to the [USDOE] * * * the portion (or all) of such installment that exceeds such eligible amount." A conclusion that the Direct PLUS Loan proceeds are property of the debtor for purposes of §§ 544 and 548 and available for distribution to a debtor's creditors would undermine the purposes of the HEA and disregard the parent-debtor's lack of possession and control over the Direct PLUS Loan proceeds. *Id.* at 386.

> Here, Mr. DeMauro never possessed or held the Direct PLUS Loan proceeds prior to their being paid to the University. Additionally, Mr. DeMauro lacked any

> control over how the USDOE would disburse the proceeds. The Direct PLUS Loan proceeds were restricted government funds issued to the University for the limited purpose of paying Alyson DeMauro's tuition and other qualified education-related expenses. Permitting Direct PLUS Loan proceeds to be used to pay non-educational expenses violates the provisions of the HEA and its corresponding regulations and runs counter to Congress's clear intention expressed in the criminal sanctions the debtor would be exposed to had he used the loan proceeds to pay his creditors.[17]

V. LEGISLATIVE RESOLUTION:

In certain jurisdictions, amendments have been made to the Uniform Fraudulent Transfer Act to resolve the issue of whether tuition payments can be avoided as fraudulent conveyances. Thus, the Connecticut General Assembly amended §52-552i of the Connecticut Uniform Fraudulent Transfer Act, entitled "Defenses, Liability, and Protection of Transferee," to add a provision shielding undergraduate tuition payments from recovery as constructive fraudulent transfers. This provision provides:

> A transfer or obligation is not voidable under subdivision (2) of subsection (a) of section 52-552e or 52-552f against an institution of higher education, as defined in 20 U.S.C. 1001, if the transfer was made or obligation incurred by a parent or guardian on behalf of a minor or adult child in furtherance of the child's undergraduate education.[18]

VI. INITIAL VS. IMMEDIATE OR MEDIATE TRANSFEREE:

While the most common dispute involving efforts to avoid tuition payments as fraudulent transfers revolves around the issue of whether the debtor received reasonably equivalent value for his or her tuition payments, as noted in *In re Teston,* 646 B.R. 417 (Bankr.D.Md.2022), it is not the only issue. In *Teston*, the Chapter 7 Trustee brought a fraudulent transfer action against the University of Maryland, College Park contending that tuition and other payments made to the University by the debtor on behalf of his adult son were avoidable fraudulent transfers under §548(a)(1)(B) and recoverable under Section 550 of the Bankruptcy Code.

Here, the University did not dispute that the trustee has stated a *prima facie* claim that the tuition payments were fraudulent transfers under §548(a)(1)(B). Rather, the issue was whether the University was the initial transferee of the payments, or an immediate or mediate transfer under §§ 550(a)(1) or (2).

Section 550(a) provides:

> to the extent that a transfer is avoided under [§548], the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from -

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17 *Id.* at 386-87.

18 2027 CONN. ACTS 17-50 (reg. Sess.) (codified at CONN. GEN. STAT. §52-552i).

> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.[19]
>
> However, pursuant to Section 550(b) of the Bankruptcy Code:
>
> The trustee may not recover under [§550(a)(2)] from –
>
> (1) a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided; or
>
> (2) any immediate or mediate good faith transferee of such transferee.

Thus, §550(b) provides an affirmative defense to a trustee's effort to recover an otherwise avoidable fraudulent transfer from an immediate or mediate transferee. *Teston* noted that to be an initial transferee, one must "exercise legal dominion and control over the property" in question. That test requires more than physical dominion and control. "[T]he minimum requirement of status as a 'transferee' is dominion over the money or asset, the right to put the money to one's purposes." *Id.* at 423 (quoting *Bowers v. Atlanta Motor Speedway (In re Southeast Hotel Props.)*, 99 F.3d 151, 154 (4th Cir.1996)).

In answering this question, the court spent a considerable amount of time describing the university's electronic billing system. For example, it noted that in accordance with federal requirements under the Family Educational Rights and Privacy Act, 20 U.S.C. §1232g and the university's policy, the student's account was exclusively accessible by the individual student. The student's parents, legal guardians, or other interested parties had no rights to non-public information related to the student's account, including charges, credits, and balance information. *Id.* at 420. It noted that any payment that went towards a student's account, "even if paid by a parent or other individual or entity," was treated as if it is a payment that came directly from the student for purposes of 1098-T tax reporting, as well as for purposes of determining who was entitled to any refunds. *Id.* at 420-21.

A refund of the credit can be requested by the student and obtained via direct deposit or paper check, if an overpayment was made, or if a university charge was subsequently reversed by the university, or a student withdrew from some or all courses for a term during the eligible refund period of a term. *Id.* at 421. And only the student could access this refund. Given this refund policy, the court noted that the university "essentially acted as a financial institution or intermediary * * * akin to a financial institution maintaining a bank account." *Id.* at 425 (quoting *In re Hamadi*, 597 B.R. 67, 73(BankrD.Conn.2019)). Thus, the court stated, the registration payments were legally akin to a deposit.

> The University was a mere conduit for the payments and did not have legal dominion and control over the funds. William was the initial transferee because it is he who controlled the right to either receive the funds or have them applied to his tuition by beginning the term. Once William began classes and the payments

[19] 11 U.S.C. §550(a)(1) & (2).

> could effectively be applied to tuition, the University became an "immediate or mediate transferee" of the funds entitled to assert the good faith defense of § 550(b)(1). Payments made by the Debtor during this period are not recoverable from the University.[20]

Conversely, the university was the initial transferee for payments made by the debtor after the refund period expired. "At that point the University had no obligation to return the funds and held legal dominion and control over the funds." *Id.* at 426.

> Payments made after the refund period could only be used to pay the student's tuition, and neither the Debtor nor William had any ability to use them otherwise. Payments made by the Debtor after the refund period are recoverable from the University.[21]

20 *Id.* at 425-26.
21 *Id.* at 426.

CASELAW UPDATE: AVOIDANCE ACTIONS IMPACTING DEBTORS AND CREDITOR REPRESENTATIVES IN CONSUMER CASES

I. Recent Developments in IRS Issues[1]

a. Overpayments of Estimated Taxes as Fraudulent Transfers

John Patrick Lowe Chapter 7 Tr. v. IRS (Rouquette), 2022 WL 17572677, 2022 Bankr. LEXIS 3495 (Bankr. W.D. Tex. Dec. 9, 2022)

Issue: Whether the Debtors' prepetition estimated tax payments ("ETPs") to the IRS were fraudulent transfers under § 548(a)(1)(B). Can a trustee bring avoidance actions that would have been time barred under state law by relying on the IRS as the triggering creditor?

Background:

- Debtors filed their petition for relief on Dec. 8, 2021. 2022 WL 17572677, at *2.
- Debtors made five estimated tax payments totaling $26,000 to the IRS for an estimated tax liability of $8,552 in the six months before filing for chapter 7. *Id.* at *2. The IRS filed a claim for $232,283.86. *Id.* 26 U.S.C. § 6654(d) requires estimated tax payments of the lesser of (1) 90% of the current year's tax liability; or (2) 100% of the prior year's liability. In the Debtors' case, these amounts were $21,000 and $8,552, respectively. *Id.*
- The Trustee argued three things: (1) all of the transfers were fraudulent because the Debtors failed to make the short year election required by 26 U.S.C. § 1398(d), rendering their tax liability collectible from Debtors individually, not their estate; (2) alternatively, the Debtors' overpayment, considering they could have paid only $8,552, was a transfer for no consideration under § 548(a)(1)(B); and (3) that the IRS's claim should be disallowed under § 502(d). *Id.* at *2–3.

Decision

- The parties stipulated to facts proving each element under § 548(a)(1)(B) *except* for whether the debtors received reasonably equivalent value in exchange for their estimated tax payments. *Id.*
- Regarding reasonably equivalent value, the Trustee made two arguments:
  - **First**, *all* of the estimated tax payments lacked reasonably equivalent value because the Debtors' failure to make a short year election for tax purposes under 26 U.S.C. § 1398(d) meant that no part of the Debtors' tax liability from the year the bankruptcy case commences is collectible from the estate (just collectible from the *Debtors* individually). *Id.* at *4 (citation omitted).
  - **Second**, the estimated tax *overpayments* lacked reasonable equivalent value. The Court found a helpful framing point from *In re Colliau*, 584 B.R. 812 (Bankr. W.D. Tex. 2017), which wrote: is "an estimated tax payment a payment of "present or antecedent debt," or is it a payment of future debt? If an estimated tax payment is a payment of an antecedent or present debt, then the transfer in satisfaction of the tax debt would be a dollar-for-dollar exchange, and would be for a reasonably equivalent value. If an estimated tax

[1] The author gratefully acknowledges the research assistance provided by Michael Jurkash, Associate at Steinhilber Swanson LLP, in the preparation of the tax materials.

payment is a payment of *future debt*, then it would not meet the definition of value, and could be avoidable as a fraudulent transfer." *Id.* at *5 (quotation omitted).
  - The Trustee compared what was paid and what was due only ($8,552) and argued that overpayment was not reasonably equivalent value. *Id.*
- Court held that *all* the transfers were voidable, but declined to disallow the IRS Claim and left court observers with a word of caution:

> Although the Court does find that the transfers at issue were fraudulent transfers, a word of caution is necessary. The Court holds that this Order is limited to the facts of this case and should not be construed to hold that every estimated tax payment without a debtor making a 26 U.S.C. § 1398 [short year] election is a basis for a fraudulent transfer. Notably, the Debtors here did not contest the basis for the payments, nor did they otherwise appear in this adversary proceeding. . . . [T]he timing of the payments, coupled with the prior year's tax liability, plus the fact that the tax return was not filed until three months after the due date, raise serious questions as to Debtors' intentions.
>
> *Id.* at *9.

- BAD RESULT FOR DEBTORS: estimated tax payments which were allocated to pay non-dischargeable taxes are clawed back and disbursed pro-rata to all unsecured creditors. The Debtors could have allocated these monies to an exempt asset and paid the tax post-petition.
- Consumer tips to avoid this result: If there is an adversary proceeding like this between the Trustee and the IRS in your BR case, show up to the adversary proceeding and demonstrate the basis of the underlying tax payments.

b. Using the IRS as a "Triggering Creditor" for Enhanced Avoidance Lookback Periods and Preemption of State Law

In re Spencer, 2023 WL 2563751, 2023 Bankr. LEXIS 701 (Bankr. S.D. Ill. Mar. 17, 2023)

<u>Issue:</u> Whether a Chapter 7 Trustee, using the "strong arm" powers conferred by 11 U.S.C. § 544(b)(1), may avoid a disclaimed inheritance as a fraudulent transfer pursuant to the Federal Debt Collection Procedures Act ("FDCPA" or "Act"). 2023 Bankr. LEXIS 701, at *2–3.

<u>Background:</u>
- Debtors filed their petition for relief on July 2, 2020. *Id.* at *5–6.
- The Debtor disclaimed his interest in a life insurance trust in favor of his children. *Id.* at *5.
- The Trustee asserted that because the IRS—one of the Debtor's unsecured creditors–could have avoided the disclaimer pursuant to § 3304 of the FDCPA, he could, therefore, "step into the shoes" of the IRS to avoid the transfer and recover the proceeds for the benefit of the Debtor's creditors. *Id.* at *4.
- The FDCPA, being the government's "exclusive civil procedures for the United States to recover a debt," provides for the recovery of fraudulent transfers. *Id.* at *7–8 (citation omitted).
- FDCPA fraudulent transfer provisions are virtually the same as those in the Uniform Fraudulent Transfer Act "UFTA", except that the FDCPA's six-year statute of limitations is longer than the UFTA's four. *Compare* 28 U.S.C. § 3304, with UNIF. FRAUDULENT TRANSFER ACT §§ 4–5.

- Section 544(b)(1) of the Bankruptcy Code provides that "[t]he trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable *under applicable law* by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title."

Decision:

- Court decided: (1) the FDCPA was applicable law the Trustee could assume for avoidance purposes (and step into the IRS's shoes as a "triggering creditor"); and (2) the Debtor's interest in the disclaimed inheritance was "property" for the purposes of the FDCPA, notwithstanding that Illinois law may have said otherwise.

FDCPA is "applicable law"

- Debtor argued that FDCPA is inapplicable to avoidance actions under 544(b)(1) and that Debtor's disclaimer of his inheritance meant that he never possessed an interest in property that could be transferred under the FDCPA. *Id.* at *10–11.
- Court decided to join what it called: "The majority of courts[that] have concluded that the FDCPA is applicable law for purposes of 544(b)." *Id.* at *11 (quotation marks omitted).
- "[T]he focus of the § 544(b)(1) inquiry . . . is whether the creditor into whose shoes the trustee has stepped may pursue avoidance. . . . [it] does not restrict which of the debtor's creditors the trustee chooses as the triggering" creditor." *Id.* at *12.
- Although FDCPA § 3003(c)(1) provides the Act "shall not be construed to supersede or modify the operation of title 11," 544(b)(1) is precisely the operation of title 11. *Id.* at *18 ("Once an applicable law is identified in the context of a specific case, the operation of § 544(b) is complete.") (quoted source omitted).

Disclaimed Inheritance is Avoidable "Property" Under FDCPA

- Debtors argued that because the 544 avoidance power is contingent on whether "the property he or she would otherwise recover would have been property of the estate but for the transfer[,]" the disclaimed inheritance was not avoidable, because Illinois law provides that the disclaimant is deemed to have never held an interest in the disclaimed property under Illinois law. *Id*. at *21.
- Court held IL law was not determinative, because the FDCPA's definition of "property" was a "federal provision to the contrary" and "state laws that interfere with, or are contrary to the laws of congress, made in pursuance of the constitution are invalid." *Id.* at *25 (quoting *Wisconsin Pub. Intervenor v. Mortimer*, 501 U.S. 597, 604 (1991)).
- FDCPA defines property as:

> *any present or future interest*, whether legal or equitable, in real, personal (including choses in action), or mixed property, tangible or intangible, vested or contingent, wherever located and however held (including community property and *property held in trust* (including spendthrift and pension trusts)) . . . .
>
> 28 U.S.C. § 3002(12) (emphasis added).

- Debtor held a present interest or future interest in trust under the FDCPA. *Id*. at *27. The FDCPA was enacted to provide more consistent means of US debt collection instead of following a "patchwork of laws in the fifty states." *Id.* at *29.

TAKEAWAYS: Not only can relying on the IRS as a "triggering creditor" give a 6-year lookback for avoidance power instead of the 4-years provided for by UFTA, it also bestows a definition of "property" that supersedes seemingly contrary state law.

In the October issue of the ABI Journal, Jason Brookner and Amber Carson authored an article, *Further Reflections on Using the Tax Code's Extended Period for Avoidance Under § 544(b).* AM. BANKR. L.J., OCT. 2022, 14–15, 50–51, which highlighted the availability of the "Internal Revenue Code" itself as applicable law under 26 U.S.C. § 6502, which provides that:

> Where the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy or by a proceeding in court, but only if the levy is made or proceeding begun–(1) within 10 years after the assessment of the tax."

Begier v. I.R.S., 496 U.S. 53 (1990) (pre-petition payment of non-segregated funds to IRS by debtor in satisfaction of tax withholding obligations were payments from a special fund held in trust for payment of such obligations to the IRS and was not a preferential transfer of debtor's property)

In re Ruggeri Elec. Contracting, Inc., 199 B.R. 903 (Bankr. E.D. Mich. 1996), *aff'd*, 214 B.R. 481 (E.D. Mich. 1997) (IRS prepetition levy on funds in debtor's bank account constituted transfer of interest of debtor in property, rather than payment of trust-fund taxes, for preference avoidance purposes; due to the fact that debtor never made voluntary payment of trust-fund tax obligation as in *Begier*)

MECHANIC'S LIEN WAIVERS AND WAGE GARNISHMENTS AS PREFERENTIAL TRANSFERS[1]

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[1] The author would like to thank Joy Kleisinger at Frost Brown Todd LLP for her assistance with the materials.

I. <u>Introduction</u>

Section 547 of the Bankruptcy Code allows a trustee to recover a preferential transfer made by the debtor to a party within 90 days of the debtor's bankruptcy filing, so long as that transfer was made on account of an antecedent debt (among other requirements). A split in authority exists regarding whether certain common transfers made by debtors are preferential and subject to avoidance and recovery by a trustee: waivers of mechanic's lien rights under state law and wage garnishments initiated outside the preference period. The following materials provide a survey of relevant case law addressing these issues, which continue to impact both consumer debtors and their creditors.

II. <u>Wage Garnishments: Timing and Preference Defenses.</u>

A dispute exists among courts regarding whether garnishment orders initiated prior to the preference period, but where wages are garnished during the preference period, constitute preferential transfers. While most courts examining this issue have concluded that the garnishment of wages during the preference period are subject to avoidance and recovery by a trustee, a minority of courts have concluded that those garnishments are not subject to avoidance and recovery under the Bankruptcy Code. However, the cases in the minority regarding the preferential characterization of garnishments recent precedent and may, in fact, no longer represent good law.

i. <u>Cases determining that garnishments occurring during the preference period *are* avoidable and recoverable as preferential transfers.</u>

The court in *In re Smith*, 635 B.R. 784 (Bankr. E.D. Mo. 2022), recently evaluated whether a debtor's garnished wages totaling $710.63 that were earned during the preference period were avoidable and recoverable by the trustee as a preferential transfer. The *Smith* court found that the relevant inquiry was when the debtor *earned* the wages rather than when the debtor was *paid* the wages. In *Smith*, the debtor earned the wages subject to the garnishment order during the preference period; therefore, according to the *Smith* court, the trustee could recover the garnished wages as a preferential transfer. Had the debtor earned the wages prior to the preference period and merely had the wages garnished during the preference period, the *Smith* court likely would have reached a different conclusion.

In *In re Stevens*, 552 B.R. 773 (Bankr. D. Colo. 2016), the court found that, even though the initial state court garnishment writ was served prior to the 90-day preference period, each garnishment occurring within the preference period constituted a preferential transfer. Similar to the *Smith* court, here the court found that the timing of the wages, meaning when they were earned rather than the time of collection, determined whether each individual act of garnishment constituted a preferential transfer.

The Fifth Circuit in *Matter of Jackson*, 850 F.3d 816 (5th Cir. 2017), relying on the Supreme Court decision of *Local Loan Co. v. Hunt*, 292 U.S. 234, 54 S. Ct. 695, 78 L. Ed. 1230 (1934), found that a lien, such as a garnishment, perfected outside of the preference period does not impact the status of garnished wages inside the preference period. Specifically, the Fifth Circuit noted that under § 547(e)(2)(B) of the Bankruptcy Code, a transfer is generally made at the time it is perfected "which, in the context of non-real property, occurs when 'a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee.'" The court noted, however, that § 547(e)(3) qualifies that general principle and provides that "a transfer is not made until the debtor has acquired rights in the property transferred." Accordingly, the relevant inquiry in determining whether garnished wages may be subject to avoidance under § 547 of the Bankruptcy Code is when the debtor earned the wages. The court then found that the debtor's garnished wages earned during the preference period were subject to avoidance and could be recovered by the trustee.

The court in *In re Garcia*, 2017 WL 1379332 (Bankr. D.N.M. 2017), ultimately reached the same conclusion as that in the *Jackson* case, but instead relied on another Supreme Court case, *Barnhill v. Johnson*, 503 U.S. 393, 112 S.Ct. 1386, 118 L.Ed.2d 39 (1992). In *Barnhill,* the Supreme Court evaluated whether the transfer of funds via check occurred for preference purposes when the check was received versus when the check was deposited. The *Barnhill* Court determined that, under federal law, a transfer of funds occurs when the recipient takes possession of the funds, meaning that the timing of avoidable preferences depended on when the funds were ultimately transferred. The *Garcia* court applied this holding to garnishment cases, finding that the timing of a garnishment for preference purposes did not depend on the date of the garnishment lien, but rather, when the debtor earned the wages such that the garnished funds were transferred to the judgment creditor. The court accordingly determined that the garnished wages transferred during the preference period were avoidable under § 547 of the Bankruptcy Code.

The court in *In re Wade*, 219 B.R. 815 (B.A.P. 8th Cir. 1998), also found that wages earned during the preference period and subject to garnishment were preferential transfers subject to recovery by the trustee. The court specifically found that because § 547(e)(3) requires that, for a transfer to be preferential, that the transfer be relegated to when the lien becomes effective, under Missouri law, the wages earned by the debtor during the preference period were subject to avoidance.

ii. Cases determining that garnishments initiated outside the preference period are *not* avoidable and recoverable as preferential transfers.

In contrast, the court in *In re Coppie*, 728 F.2d 951 (7th Cir. 1984), applying Indiana law, held that a garnishment acts as an absolute assignment of the debtor's future wages, meaning that the payment of wages during the preference period subject to garnishment cannot be avoided and recovered as a preferential transfer. The *Coppie* court focused on the inevitability of the acquisition of wages, finding that following the issuance of a garnishment, the debtor never actually acquired rights in those wages. However, *Coppie* was recently overruled by the Seventh Circuit Court of Appeals in *Warsco v. Creditmax Collection Agency, Inc.*, 56 F.4th 1134 (7th Cir. 2023), which found that federal law, rather than state law, controls whether a transfer occurred for preference purposes. Specifically, the *Warsco* court noted that the *Coppie* opinion was based on pre-*Barnhill* precedent, which impacts the definition of a "transfer" under the Bankruptcy Code. In *Warsco*, the court found that actual payments, rather than the timing of the garnishment order, count as a transfer under the holding of the *Barnhill* case, and that the garnished wages of a debtor earned in the preference period are therefore subject to avoidance and recovery as a preferential transfer.

Reaching a similar conclusion, the court in *In re Conner*, 733 F.2d 1560 (11th Cir. 1984), relied on § 547(e)(1)(B) and held that, because no contract creditor could obtain a superior judicial lien after a garnishment was executed, the transfer occurred at the time of the execution. Accordingly, because the relevant inquiry was the date of execution of the garnishment, the trustee could not recover the garnished wages earned during the preference period.

iii. Cases Finding that *De Minimis* Garnishments are not Recoverable.

A notable case finding that garnished wages earned during the preference period were not preferential transfers is *In re Pierce*, 779 F.3d 814 (8th Cir. 2015). However, this case is meaningfully different from the aforementioned cases finding garnishments to be non-avoidable, because the denial of preferential treatment is based on the amount of the garnishment rather than the timing of the garnishment. In *Pierce*, the court found that, because the total wages garnished amounted to less than $600, the trustee could not recover those garnished wages under § 547(c)(8). Similarly, the court in *Matter of Hailes*, 77 F.3d 873 (5th Cir. 1996) found that, while the wages at issue were earned during the preference period and garnished would ordinarily be subject to avoidance by the trustee, the de minimis value of the wages under § 547(c)(8) rendered the wages unrecoverable.

III. Mechanic's Lien Waivers in the Context of Preference Actions.

Courts differ in their approach to the treatment of mechanic's lien waivers executed during the preference period. Mechanic's liens are created by state-specific statutes and thus results may vary based on jurisdictional requirements but, generally, contractors and other construction-related entities may waive their rights to file a mechanic's lien associated with a specific project in exchange for payment. Some bankruptcy courts have held that such an exchange during the preference period still entitles the non-debtor party to a defense to preference actions under § 547(c)(6) of the Bankruptcy Code, while others have determined that a creditor's failure to perfect (or a waiver of the right to perfect) a mechanic's lien does not entitle the creditor to a defense to preference actions.

i. Cases finding that mechanic's lien waivers can be construed as preferential transfers.

In *In re JWJ Contracting Co., Inc.*, 287 B.R. 501 (B.A.P. 9th Cir. 2002), the Bankruptcy Appellate Panel of the Ninth Circuit found that, under Arizona law, the preference defendant's unconditional waiver of its lien rights in exchange for payments by the debtor rendered the new value defense asserted by the defendant inapplicable. The Court emphasized that, because the defendant affirmatively waived all its mechanic's lien rights under A.R.S. § 33–1008, the defendant merely released an unsecured claim in exchange for payment due to the defendant's failure to file a mechanic's lien. *Id.* at 509.

In *In re Globe Manufacturing Corporation,* 2008 WL 11449037 (N.D. Ala. 2008), the court found that, under Massachusetts law, the defendant failed to properly perfect a mechanic's lien and thus could not use an "equitable lien theory" to defend its otherwise avoidable transfer. Specifically, the defendant waived its right to file a mechanic's lien in exchange for payment from the debtor. The court emphasized that state law governs mechanic's liens and, because Massachusetts unequivocally does not recognize equitable mechanic's liens, the defendant could not rely on this theory as a defense to the preference action.

Similarly, the court in *Precision Walls, Inc. v. Crampton,* 196 B.R. 299 (Bankr. E.D.N.C. 1996), looked at state law and determined that strict compliance with North Carolina's mechanic's lien statutes was required to obtain secured creditor status. Here, the defendant argued that, had it not waived its mechanic's lien rights in exchange for payment, it could have filed and perfected its mechanic's lien and was thus entitled to secured treatment under the Bankruptcy Code. However, the court denied this argument, stating that the defendant was required to perfect its mechanic's lien in order to raise its secured status as a defense to the preference action.

ii. Cases finding that Mechanic's Lien Waivers are not Subject to Recovery Under Section 547 of the Bankruptcy Code.

In *In re BFN Operations, LLC*, 2019 WL 2387168 (Bankr. N.D. Tex. 2019), the court determined that the transfer made from the debtor to the defendant contractor in exchange for the execution of a lien waiver was not preferential under § 547(b)(5). Here, the defendant waived its mechanic's lien rights in exchange for full payment of the invoices issued to the debtor, which payment was made during the preference period. Under the inchoate lien defense, the defendant could not execute its lien after accepting payment in full, and that a court's refusal to acknowledge the lien would create undue hardship on similarly situated contractors, namely, whether to accept full payment and risk an avoidance action or deny payment to protect its secured status. Ultimately, the court found that the defendant raised a valid defense and was not subject to preference liability.

In *In re Carney,* 396 B.R. 22 (Bankr. N.D. Iowa 2008), the court interpreted Iowa mechanic's lien law to determine that payments to the defendant mechanic were not preferential. Iowa law provides that mechanic's liens attach to the subject property and continue until 90 days after the job is completed, and are valid against all other subsequent liens. If the party fails to perfect its lien following the 90-day period, the lien remains valid against all subsequent liens, except for good faith purchasers and parties without notice of the lien. The court found that the defendant's mechanic's lien would have been subordinate to the trustee as the hypothetical good faith purchaser, but that the trustee failed to prove that the defendant was better off than it would have been in a chapter 7 liquidation by receiving the allegedly preferential payments, meaning that the trustee failed to carry its burden under § 547(b)(5).

The court in *Betty's Homes, Inc. v. Cooper Homes, Inc.*, 411 B.R. 626 (W.D. Ark. 2009), similarly analyzed Arkansas mechanic's lien law, which allows for the relation back of a mechanic's lien upon perfection such that the lien remains inchoate until either it is perfected or expires. Here, the defendant had multiple inchoate liens on the debtor's properties when the debtor made the allegedly preferential payment transfer. However, because the liens had not expired, the court found that the defendant was indeed a secured creditor and protected from the avoidance action.

In *In re Golfview Development Center, Inc.*, 309 B.R. 758 (Bankr. N.D. Ill. 2004), the court similarly applied Illinois mechanic's lien law to determine whether a preference defendant was entitled to inchoate lien defense. The court found that, because the defendant mechanic was paid during the preference period but still met all prerequisites for bringing a lien claim, the defendant was a secured party for avoidance purposes. Accordingly, the defendant could not be held liable under § 547(b)(5) of the Bankruptcy Code because it was still considered a secured party.

In *In re ML & Associates, Inc.*, 301 B.R. 195 (Bankr. N.D. Tex. 2003), the court evaluated the secured status of the subcontractor preference defendant under Texas law to determine whether it could be held liable in an avoidance action. To determine the defendant's secured status, the court constructed a hypothetical chapter 7 liquidation on the petition date and, assuming the transfer had not been made, whether the defendant was better off for having received the payments at issue. Ultimately, the court determined that, in either scenario, the defendant would have received 100% of the outstanding invoices due to the bonded status of the project. The court found that the trustee failed to carry the burden under § 547(b)(5) and found the transfer to be unavoidable by the trustee.

In *In re 360Networks (USA) Inc.*, 327 B.R. 187 (Bankr. S.D.N.Y. 2005), the court evaluated whether payments made subject to inchoate liens could be successfully avoided by the trustee. Here, the court found that, because the payments represented the secured interest of the defendant, it would be impracticable to then allow the trustee to avoid the transfer and get around the defendant's otherwise secured status. Accordingly, the defendant was not subject to preference liability.

Faculty

Hon. James W. Boyd is a U.S. Bankruptcy Judge for the Western District of Michigan in Grand Rapids, appointed in May 2014, and presides over bankruptcy matters in Grand Rapids and Traverse City. Prior to his appointment, he was a partner in the law firm of Kuhn, Darling, Boyd and Quandt PLC in Traverse City, Mich., where he practiced in the areas of bankruptcy law and commercial litigation. From 1988-2014, he served as a chapter 7 panel trustee and as a chapter 11 operating and liquidation trustee in many cases. While a trustee, he served on the board of directors of the National Association of Bankruptcy Trustees from 1999-2013 and was its president in 2010. He has also served as an operating and liquidating receiver under Michigan law for numerous entities. Judge Boyd is a contributing author to ICLE's *Handling Consumer and Small Business Bankruptcies* and is a member of the Federal Bar Association and ABI, as well as a frequent speaker. He received his J.D. from the Thomas M. Cooley Law School.

Matthew T. Gensburg is senior counsel with Gensburg Calandriello & Kanter, P.C. in Chicago and leads the firm's bankruptcy, commercial litigation and restructuring practice group, with an emphasis in financial services. He has more than 30 years of legal experience in bankruptcy, financial restructuring and related matters On behalf of secured and unsecured lenders, lessors, creditors' committees and debtors in all phases of corporate reorganizations and debt structuring, he manages breach-of-contract, settlement agreements, civil lawsuits, collections, post-judgment enforcement, and the purchase and sale of assets. Mr. Gensburg is the former chair and current member of the Chicago Bar Association's *Pro Bono* Bankruptcy Committee, and throughout his career he has assisted *pro se* debtors with various aspects of chapter 7 and 13 bankruptcy cases before the U.S. District Court in the Northern District of Illinois. In addition to monitoring the committee's cases and managing his own *pro bono* cases, Mr. Gensburg oversees fundraising and lawyer recruitment on behalf of the CBA committee. He was the past program chair and is a current advisory board member ABI's Central States Bankruptcy Workshop. As a frequent lecturer to business and professional groups, Mr. Gensburg instructs loan officers and attorneys on the Bankruptcy and Uniform Commercial Codes and statutory state options. Earlier in his career, he lectured as a faculty member of the American Bankers Association's National Commercial Lending School and Commercial Lending Graduate School, as well as to members of the National Business Institute on bankruptcy law and procedure. He is a frequent author and contributor to industry publications and formerly published a monthly "Business and the Law" column in the *Kane, McHenry* and *Lake County Business Journals* for many years. He also contributed to *Pratt's Journal of Bankruptcy Law*. He has also published course materials on behalf of the National Business Institute and Lorman Educational Services. Mr. Gensburg formerly served on the Board of Editors of the *Annual Survey of Bankruptcy Law*. He received his B.A. in 1980 from the University of Michigan and his J.D. in 1983 from Emory University School of Law.

Virginia E. George is a partner at Steinhilber Swanson, LLP in Oshkosh, Wis., and has served as a chapter 7 panel trustee in the U.S. Bankruptcy Court of the Eastern District of Wisconsin (Milwaukee Division) since 1999. She primarily concentrates her practice in bankruptcy and insolvency matters. Ms. George has served as operating receiver in state and federal court and represented a national lender in its Special Assets Division. Some of her notable outcomes include collecting a $20 million Petroleum Environmental Clean-up Fund Act portfolio for a national lender and winning the largest punitive damage verdict in state history for 27 families defrauded by a bank. Most recently, she successfully negotiated the sale of "The Bull Golf Course," all during a statewide COVID-19 shutdown, and negotiated and won approval of the sale of ITO Industries, a shuttered electric bare-board manufacturer, both in her role as chapter 7 trustee. She is rated AV-Preeminent by Martindale-Hubbell. Ms. George received her J.D. from Marquette University Law School.

A.J. Webb is a partner with Frost Brown Todd LLC in Cincinnati and counsels companies facing varying degrees of financial uncertainty and distress, working to proactively identify and assess insolvency issues. He represents secured/unsecured creditors, debtors, committees, purchasers and borrowers in all phases of bankruptcy and insolvency proceedings, with an emphasis on selling or acquiring distressed assets and assisting parties in restructurings or out-of-court workouts. Additionally, he counsels clients on general corporate and commercial matters, as well as Uniform Commercial Code matters (with an emphasis on health care receivables), and he has prosecuted or defended numerous avoidance actions. Prior to joining Frost Brown Todd, Mr. Webb was a financial sales associate for a major brokerage institution, and later worked for a nonprofit arts organization. His prior work experience provided him with a unique perspective on the myriad financial issues affecting both for-profit and nonprofit entities. Mr. Webb received his B.A. *cum laude* in political science from Marshall University, where he was designated Outstanding Student in Political Science, and his J.D. from the University of Cincinnati College of Law, where he received the University Prize for the Second-Highest G.P.A., the Commercial Law Award for Highest Scholar in Contract, Commercial, and Bankruptcy Law, the Ernest Karam Prize and the Thompson Hine & Flory Prize.