UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.	CASE NO. 96-61376 Chapter 11
Debtors	Substantively Consolidated

UNION STATE BANK

Plaintiff

vs. ADV. PRO. NO. 97-70094A

THE BENNETT FUNDING GROUP, INC.

Defendant

APPEARANCES:

HANCOCK & ESTABROOK, LLP Attorneys for Plaintiff/Union State Bank 1500 Mony Tower I Syracuse, New York 13202	DANIEL B. BERMAN, ESQ. Of Counsel STEPHEN A. DONATO, ESQ. Of Counsel
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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT,
CONCLUSIONS OF LAW AND ORDER

This matter comes before the Court on the motion of Union State Bank (hereafter, "Union"), the plaintiff and counterclaim defendant in the above-captioned adversary proceeding, which seeks partial summary judgment on eleven of the twenty-three counterclaims asserted against it by Richard C. Breeden ("Trustee"), the Chapter 11 Trustee of the Consolidated Estate

of The Bennett Funding Group, Inc. ("Debtors"). At issue are approximately $438,943.28 in payments made by the Debtors to Union during the ninety-day period immediately preceding the commencement of this bankruptcy case on March 29, 1996 (the "Petition Date"), payments which the Trustee now seeks to avoid as preferential transfers under §§ 547 and 550 of the United States Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"). The Court also has before it a cross-motion by the Trustee which seeks an indefinite stay of Union's partial summary judgment motion, apparently on the grounds that allowing this matter to go forward would frustrate the purposes of a recent Court order which stayed certain other factually-related adversary proceedings.

The Court heard oral argument on the motions on February 11, 1999. Following the hearing, the parties were given an opportunity to prepare and file additional memoranda of law, and on February 25, 1999, both motions were submitted for decision.[1]

JURISDICTIONAL STATEMENT

The Court has jurisdiction over the parties and subject matter of this adversary proceeding pursuant to 28 U.S.C. §§ 1334 and 157(a), (b)(1), and (b)(2)(F).

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[1] Objecting to what he characterized as a "new argument" advanced in Union's supplemental memorandum of February 25, 1999, the Trustee submitted a further memorandum of law on March 8, 1999, nearly two weeks after the submission date. This in turn prompted two informal letter-memoranda by Union, dated March 10 and April 6, 1999, as well as a responding letter by the Trustee dated March 31, 1999. Since neither party ever sought an extension of the submission deadline, these untimely communications will be disregarded in their entirety for purposes of this decision. *See In re Mark Twain Marine Industries, Inc.*, 115 B.R. 948, 949 (Bankr. N.D. Ill. 1990).

BACKGROUND

The Debtors are a network of finance and finance-related companies formerly controlled by members of the Bennett family of Syracuse, New York. On March 29, 1996, amidst allegations of criminal securities fraud by the Bennetts and several of their associates, four of the Debtor companies filed for Chapter 11 protection in this Court. Following the appointment of the Trustee pursuant to Code § 1104 on April 18, 1996, bankruptcy petitions were filed on behalf of four additional Bennett-linked companies, and on July 25, 1997, the estates of all eight debtors were substantively consolidated by order of the Court.[2]

Prior to bankruptcy, the bulk of the Debtors' purported business activity centered around its acquisition of office equipment leases. In a typical transaction, the Debtors would arrange with an equipment vendor to provide financing services to its customers at the point of sale, providing cash to the vendor and simultaneously entering into a long-term lease with the buyer, or "end-user." After acquiring a sufficient number of leases in this manner, the Debtors would assemble the leases into portfolios, which would then be pledged or sold to investors or lenders[3] in exchange for new capital. These latter transactions were usually memorialized by a "bill of

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[2] The eight companies which comprise the Consolidated Estate are The Bennett Funding Group, Inc.; Bennett Receivables Corporation; Bennett Receivables Corporation II; Bennett Management & Development Corporation; The Processing Center, Inc.; Resort Service International, Ltd.; American Marine International, Ltd.; and Aloha Capital Corporation.

[3] Throughout this bankruptcy case, various parties have disputed whether the entities that entered into transactions of this type with the Debtors are more properly described as "lenders" or as "investors." Nothing in the present matter, however, appears to hinge on which term is used to characterize Union. As a matter of convenience, the Court will use these terms interchangeably, but makes no findings of fact or law regarding the status of any entity so described.

sale" which purported to convey all right and title in the leases and the underlying equipment to the lender or investor; at the same time, the investors would be required to sign a "servicing agreement," which authorized the Debtors to continue to collect lease payments from the end-users on the investors' behalf. In practice, this system meant that the investors would receive a monthly payment from the Debtors in a predetermined amount which purportedly equaled the lease collections minus the Debtors' servicing fee. Because of this, the investors would in general have no direct contact with any of the end-user lessees.

The exact legal characterization of these transactions remains an issue in considerable dispute. Along with numerous similarly-situated lenders and investors, Union asserts that it is now the true owner of certain leases, the cash proceeds of the leases, and the underlying equipment by virtue of the bills of sale. The Trustee, however, contends that the Debtors conveyed, at most, a security interest in this property, title to which remained with the Debtors at all times.

Between 1990 and 1994, Union provided funding to the Debtors on twelve separate occasions, in return for which it was given an interest in twelve lease portfolios. The Debtors appear to have completed their payment obligations to Union under the first two of these transactions more than ninety days before the Petition Date. Consequently, only the last ten of these loans (respectively, "Loan 1" through "Loan 10") are at issue in the present motion.[4]

Shortly after the commencement of this bankruptcy case, which resulted in a default of the Debtors' payment obligations to Union, Union moved for an order modifying the automatic

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[4] The Court notes, however, that at least some of the payments made pursuant to the two completed loans are being attacked by the Trustee as fraudulent conveyances. These causes of action are not addressed by the summary judgment motion presently under consideration.

stay extended to the Debtors by operation of Code § 362. Among other relief, Union sought permission to terminate the servicing agreement, permission to undertake collection on the leases directly from the end-users, and turnover of any funds arising from its leases which had been received by the Debtors since the Petition Date. All of these requests were opposed by the Trustee, and on June 11, 1996, the Court denied the turnover portion of Union's motion without prejudice. However, as a provisional measure, the Court ordered the Trustee to deposit all future lease collections claimed by Union into a segregated escrow account pending final resolution of the lift-stay motion.

Because Union's motion for relief from the stay involved questions of law and fact that were largely indistinguishable from the lift-stay motions of numerous other banks, the parties were encouraged to address these issues, to the extent possible, through consolidated litigation. *See In re The Bennett Funding Group, Inc.*, 203 B.R. 30 (Bankr. N.D.N.Y. 1996). Among these common questions of law was the Trustee's argument that, pursuant to Code § 502(d), he could assert the existence of fraudulent and preferential pre-petition transfers as an affirmative defense to the banks' demands for turnover, an argument which the Court agreed to consider as a discrete submitted matter in late 1996. In its subsequent decision, issued on January 8, 1997, the Court determined that it would not consider the Trustee's avoidance arguments in its adjudication of the lift-stay motions, and instead directed the Trustee to assert his avoidance claims in separate adversary proceedings. *In re The Bennett Funding Group, Inc.*, No. 96-61376 et seq. (Bankr. N.D.N.Y. 1997) (the "January 8 Decision").

The immediate effect of the January 8 Decision was to clear the way for dozens of evidentiary hearings on the banks' lift-stay motions, several of which were decided on an

individualized basis in the spring and summer of 1997. Shortly before the scheduled date of Union's own evidentiary hearing, however, Union elected to replace its original lead counsel, the law firm of Kurtzman, Cohen, Matera & Gurock, with its then-local counsel, Hancock & Estabrook, L.L.P. Shortly afterwards, Union moved to withdraw its original motion and file in its place the complaint in the present adversary proceeding, which sought substantially similar relief.[5] Over the objections of the Trustee, the Court permitted Union to make this substitution by an oral order of May 8, 1997.

On May 28, 1997, the Trustee filed an answer to Union's new adversary complaint, along with which he asserted twenty-three counterclaims. In addition to the eleven preference causes of action at issue in the present motion,[6] the Trustee's counterclaims sought a determination that Union held only an unperfected security interest in the lease proceeds, which he accordingly sought to avoid pursuant to Code § 544. Owing to what was characterized as an oversight by counsel, however, the Trustee also commenced a separate adversary proceeding against Union, designated as Adversary Proceeding 98-70027A, the contents of which largely duplicated the counterclaims which had been filed in Union's adversary proceeding. This 1998 adversary complaint is notable as the first instance during the course of his litigation with Union that the

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[5] For all practical purposes, the 1997 adversary complaint differed from the 1996 motion only in that it sought declaratory as well as injunctive relief, and in that it reinstated the request for turnover which had previously been denied without prejudice. While it does not appear that the Court ever vacated its segregation order of June 11, 1996, a virtually identical (and arguably redundant) segregation order was entered on May 28, 1998 in response to Union's adversary complaint.

[6] The first through tenth of these counterclaims correspond to Loan 1 through Loan 10, as numbered in this Decision. The Trustee's eleventh counterclaim seeks turnover of all amounts sought to be avoided under the first ten counterclaims.

Trustee specifically raised the allegation that the Debtors had operated a "Ponzi" type scheme prior to their bankruptcy. On March 17, 1999, the Court dismissed the duplicative causes of action in the 1998 Adversary Proceeding, dismissed the non-duplicative causes of action in part, and ordered the surviving non-duplicative claims consolidated with the counterclaims of the present adversary proceeding pursuant to Rule 7042 of the Federal Rules of Bankruptcy Procedure ("Fed.R.Bankr.P."). *See Breeden v. Union State Bank (In re The Bennett Funding Group, Inc.)*, Adv. No. 98-70027A (Bankr. N.D.N.Y. March 17, 1999).

In September of 1997, a group of approximately 21 non-settled banks, including Union, reached an agreement with the Trustee regarding a consolidated hearing on their motions for relief from the automatic stay. *See Stipulation Regarding Lift-Stay Litigation by Bank of Carmi and Banks Identified Below That Have Not Yet Had Evidentiary Hearings Regarding Transactions With The Bennett Funding Group, Inc.* (September 25, 1997) (the "Carmi Stipulation"). Under the terms of the Carmi Stipulation, which was approved by the Court in an Order of October 22, 1997, Union and the other signatory banks were given the right to participate as intervenors in an evidentiary hearing on a lift-stay motion filed by the Bank of Carmi et al. ("Carmi"), which was scheduled for January 28, 1998. With respect to the lift-stay motions of banks other than Carmi, the Trustee and the signatory banks stipulated that the Court's decision in the Carmi matter would have binding effect on the parties for all legal and factual questions, excepting a narrow category of specifically-defined "non-common issues." The list of non-common issues included, *inter alia*, facts relating to the valuation of specific leases in which the banks claimed an interest, facts relating to the performance of specific lease portfolios, and facts relating to the dates and manner in which a bank filed financing statements in order to

perfect its purported security interests under New York's version of the Uniform Commercial Code ("UCC").

The Court issued a decision in the Carmi matter on May 6, 1998. ("Carmi Decision"). In pertinent part, the Carmi Decision held that the post-petition, post-segregation payments made pursuant to Carmi's leases were subject to Carmi's perfected security interest. Among the common issues decided by the Court in reaching this determination were, first, that the leases in which Carmi claimed an interest were generally "chattel paper" for purposes of the UCC. *See* Carmi Decision, Slip. Op. at 12. With respect to the leases and lease proceeds, it was, therefore, unnecessary to decide whether the transaction was a secured loan or a sale of chattel paper, since both of these transactions are treated identically by Article 9 of the UCC. *See In re The Bennett Funding Group*, *Inc*., 203 B.R. at 34.[7] Secondly, the Court concluded that Carmi's security interest in the leases became perfected both by its possession of the ink-signed original lease documents, as well as (in some but not all cases) by its proper filing of financing statements with the applicable state or county authorities. *See* Carmi Decision at 20. Third, the Court found that because of an incorrect designation of one of the Debtors, certain financing statements filed in Onondaga County, New York were invalid.[8] *Id.* at 42. Fourth, the Court concluded that with

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[7] This analysis does not apply to the underlying equipment, however, in which the banks have also claimed ownership. The Court has not yet had occasion to determine whether the standard bank transactions constituted a sale or merely created a security interest in the equipment, and it does not reach this issue today.

[8] The Court also found that the Debtors maintained a place of business in more than one county of New York between December 1, 1992 and August 31, 1994. *See* Carmi Decision at 41. This finding was significant in that the Court also concluded that the financing statements filed with the New York Secretary of State were not defective. Because New York law requires that financing statements be filed with a county clerk only where the debtor does not maintain places of business in multiple counties within the state, the Secretary of State financing

respect to those leases for which a valid financing statement had been properly filed, the filing sufficed to give Carmi a perfected security interest in the leases as well as in their identifiable cash proceeds pursuant to UCC § 9-306(3)(b). *Id.* at 45. Fifth, the Court concluded that even where no valid financing statement for the underlying collateral had been filed, Carmi's security interest in the post-petition, segregated lease payments became perfected by operation of UCC §9-306(3)(c) and Code § 546(b).

The Court did not terminate the servicing agreement between the Estate and Carmi, but instead ordered the Trustee to continue collecting payment on the non-expired leases, with the proceeds, minus a service charge, to be turned over to Carmi along with any lease payments that had been collected by the Trustee since the entry of the segregation order. However, the Trustee was authorized to temporarily deduct from this turnover a "holdback" in an amount equal to his pending preference claims against Carmi. *Id*. at 88. In accordance with the terms of the Carmi Stipulation, the Trustee has made payment on similar terms to Union, subject also to a provisional holdback of the amount claimed from Union as preferences.

A final event of relevance to this motion was the filing by the Trustee in mid-1998 of over 1,000 adversary complaints which sought to recover alleged preferential transfers from various non-investor entities who had received payment from the Debtors within ninety days of the petition date, the vast majority of whom appear to be equipment retailers and trade vendors (the "Trade Vendor" actions). At an early stage of the Trade Vendor proceedings, it became clear that the outcome of those actions would likely hinge on whether trade creditors can rely on the

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statements were sufficient to perfect Carmi's security interests between December 1992 and August 1994. *See* New York UCC § 9-401(c) (McKinney's1990 & 1999 supp.)

"ordinary course of business" defense of Code § 547(c)(2) where the debtor is found to have operated a Ponzi scheme, a legal issue of first impression in this District. In an effort to adjudicate this issue in a manner that would be both administratively efficient and fair to all parties involved, the Court imposed a limited stay on all of the trade vendor adversaries on December 4, 1998, and at the same time directed the parties to negotiate a process for the consolidated litigation of the Code § 547(c)(2) issue. This stay was not extended, however, to Union or to the other banks against whom preference claims were pending.

FACTUAL STATEMENT

Under Rule 7056-1 of the Local Bankruptcy Rules for the Northern District of New York, a party moving for summary judgment is required to submit a short and concise statement of material facts which the movant contends are undisputed, while the party opposing the motion is required to submit a corresponding statement of disputed facts. Both parties to the present motion have complied with this rule. As additional support of its motion, Union has submitted the affidavit of one of its officers, William O'Neil ("W. O'Neil"), as well as the 1997 affidavit of Jerome M. Arcy ("Arcy"), an affidavit which was originally submitted by the Trustee in connection with another adversary proceeding. The Trustee has offered affidavits in opposition from several employees of the Debtors, including two affidavits by Paul Szlosek ("Szlosek") (respectively, "1997 Szlosek Affidavit" and the "1999 Szlosek Affidavit"), as well as affidavits by Frank T. Halligan ("Halligan"), Christopher Pulver ("Pulver"), and Shaun O'Neill ("S. O'Neill"); an affidavit by Manny A. Alas ("Alas"), a forensic accountant previously retained by

the Estate; and excerpts from the criminal trial of Patrick R. Bennett, a former officer of the Debtors.

A. Undisputed Facts

Between December 31, 1995, and March 29, 1996, Union received approximately thirty payments from one or more Debtor entities pursuant to the ten loan transactions at issue in this adversary proceeding. The relevant data concerning these transactions are summarized by Table A, below:

TABLE A: LOAN PAYMENTS WITHIN 90 DAYS OF THE PETITION DATE

Loan #	Loan Date	Loan Amount	Total Payments Between 12/31/95 and 3/29/96
1	09/09/1991	$393,356.16	$4,616.37
2	09/11/1991	$397,371.39	$7,020.36
3	09/12/1991	$318,657.21	$4,872.00
4	09/13/1991	$389,795.70	$5,934.09
5	07/28/1992	$864,101.92	$10,014.90
6	09/09/1993	$499,983.98	$53,590.08
7	10/29/1993	$1,199.980.05	$85,036.05
8	07/29/1994	$1,000,000.15	$82,453.23
9	08/31/1994	$999,983.96	$77,640.10
10	10/14/1994	$1,999,990.29	$107,766.10

For the most part, it is agreed that the total transfers under each loan represent the three monthly payments due to Union for the months of January 1996, February 1996, and (depending

on the particular loan) either December 1995 or March 1996. Exceptions are the payments reported under Loan 8, for which Union has been unable to produce an amortization schedule, as well as those under Loan 7, for which Trustee has alleged that the payments were slightly in excess of the amounts actually due. In addition, the total preference payments on Loan 6 appear to include payments for all four months from December 1995 to March 1996, while the payments under Loan 10 include those due in January and February 1996 only.

All payments collected by the Trustee pursuant to these leases since June 11, 1996 have been deposited in a segregated account. By virtue of the Carmi Stipulation and the Carmi Decision, Union's security interest in these post-petition, post-segregation lease payments is perfected except in those cases where the Trustee has objected to the validity or effectiveness of individual leases.[9]

B. Disputed Facts

At the center of the Trustee's opposition to Union's summary judgment motion is his allegation that, from at least 1990 until 1996, the Debtors' lease-financing operation served as the facade for a massive Ponzi scheme.[10] While a full description of how the Debtors allegedly

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[9] While the Carmi Stipulation does not require the parties to file these objections with the Court until such time as all appeals of the Carmi Decision are resolved, the Trustee indicates that he has raised factual objections to several of the leases included in the portfolios securing Loans 9 and 10.

[10] In his supporting papers, the Trustee urges the Court to treat his Ponzi scheme allegation as an undisputed fact, apparently on the basis of the extensive evidence of this fraud included in the Trustee's exhibits and the absence of any contravening evidence by Union. In light of the fact that the Trustee has not made a cross-motion for summary judgment, however, the Court believes that a ruling on the existence of the Ponzi scheme would be both premature and unnecessary.

conducted this fraud is not necessary to the present discussion, three particular allegations raised by the Trustee deserve mention. The first is the allegation that during the entire period of their transactions with Union, the Debtors maintained a central account known as the "Honeypot," into which all lease collections were deposited and commingled with funds obtained from other sources. This practice of commingling is extensively described in the S. O'Neill Affidavit, the Alas Affidavit, and the 1997 Szlosek Affidavit. Second, the Trustee alleges that in furtherance of the Ponzi scheme, various financial data were manipulated so as to make the Debtors' lease-financing operation appear more profitable than it really was. This was allegedly done, among other methods, by the entry of non-existent leases on the Debtors' books. The Halligan Affidavit presents documentary evidence of these practices, which are also described in the trial testimony of Kenneth Kasarjian, a government witness in the criminal trial of Patrick Bennett. Third, the Trustee alleges that as a result of the Ponzi scheme, the Debtors were continuously insolvent during the ninety-day period leading up to the Petition Date. Statements of the Debtor's insolvency are found, among other sources, in the 1997 Szlosek Affidavit.

While Union apparently concedes that these affidavits would otherwise be sufficient to raise a question of fact for purposes of Fed.R.Bankr.P. 7056, it argues that principles of waiver should bar the Trustee from introducing any evidence relating to the possible existence of a Ponzi scheme at this late stage of the litigation. Union points out that the Trustee did not expressly raise his Ponzi scheme theory in the answer to Union's original lift-stay motion or in the counterclaims to Union's adversary complaint; moreover, while Union concedes that the Ponzi allegation was raised in the Trustee's duplicative 1998 adversary complaint, it notes that this was done only in the context of his fraudulent conveyance claims, not his preference claims.

While an argument not raised in a timely manner will generally be waived, the doctrine of waiver will not apply where an argument is raised at the first pragmatically possible time and where consideration of the argument would not be unduly prejudicial to the opposing party. *See American Federal Group, Ltd. v. Rothenberg*, 136 F.3d 897, 910 (2d Cir. 1998). In the present matter, the Trustee does not allege the Ponzi scheme as part of his prima facie case under Code § 547, but rather in rebuttal of an affirmative defense asserted by Union. Nor is there any significance to the Trustee's failure to allege the Ponzi scheme during the Carmi litigation, as the Court had previously indicated that it would not consider arguments related to the Trustee's avoidance claims in the context of the lift-stay motions. *See* January 8 Decision at 10. Despite Union's arguments to the contrary, it thus does not appear that the Trustee had any practical opportunity to raise his Ponzi allegation in relation to his Code § 547 counterclaims prior to the summary judgment motion presently before the Court. Moreover, even if there were such prior opportunity to raise the Ponzi allegation, Union can hardly claim to be prejudiced by its introduction at this time. Union has been on direct notice of the Trustee's Ponzi theory ever since the commencement of the 1998 Adversary Proceeding, which alleged a Ponzi scheme in connection with the fraudulent conveyance causes of action. Finally, while the word "Ponzi" never appears in the Trustee's answer to Union's complaint in this adversary proceeding, many characteristic elements of a Ponzi scheme--including the systematic commingling and misdirection of funds-- were specifically alleged. *See* Trustee's Answer and Counterclaims at ¶ 56. For the foregoing reasons, the Court concludes that the Trustee's allegation of a Ponzi scheme is not barred by waiver and may be appropriately considered in the present motion.

A second area of dispute is the manner in which the allegedly preferential payments were

received by Union. Although the W. O'Neil Affidavit, which was submitted by Union, characterizes the pre-petition payments as having been made "on a timely basis," this conclusion is apparently at odds with the data reported in the 1999 Szlosek Affidavit: of the thirty-one monthly payments that were either paid or became due in the ninety days preceding the Petition Date, Szlosek reports that twelve were not made within two weeks of the payment due date, as indicated by Table B, below.[11] While there are some discrepancies between the data reported by Szlosek and the equivalent data in the W. O'Neil Affidavit,[12] the Debtors' repayment practices as described by W. O'Neil are no less irregular. According to W. O'Neil, of the twenty-eight reported payments,[13] seven were received more than fourteen days after the invoice date, eight were received between one and fourteen days after the invoice date, one payment was not received at all, and three were received more than fourteen days before the invoice date.

TABLE B: LATE PAYMENTS OF 14+ DAYS ALLEGED BY TRUSTEE

Loan #	**Invoice Date**	**Payment Date**	**Days Elapsed**
6	12/09/1995	01/03/1996	25
7	12/29/1995	01/24/1996	26

[11] This date is listed as the "Invoice Date" in the 1999 Szlosek Affidavit. While it is not immediately clear whether the "Invoice Date" is meant to describe the date on which payments actually became due, or merely the date on which a billing statement was sent to the Debtors, the first of these interpretations is apparently borne out by Exhibit "E" of the W. O'Neil Affidavit, which characterizes those same dates as "Amortization Schedule - Amount of Payment."

[12] While the 1999 Szlosek Affidavit lists the data according to its "Payment Date," an appendix to the W. O'Neil Affidavit reports the payments according to the "Date Payment Received by Bank." While the difference between these terms is not explained, it appears that (to the extent they can be matched) the figures reported for the Payment Date consistently lag between two to four days behind the Date Payment Received by Bank.

[13] Union's data does not contain the due dates for the three payments made pursuant to Loan 8.

8	12/29/1995	01/24/1996	26
5	12/28/1995	01/26/1996	29
9	12/30/1995	01/26/1996	27
10	02/14/1996	03/04/1996	19
6	03/09/1996	03/27/1996	18
1	03/06/1996	03/27/1996	21
2	03/06/1996	03/27/1996	21
3	03/06/1996	03/27/1996	21
4	03/06/1996	03/27/1996	21
10	03/14/1996	not paid	15[14]

The final factual dispute of relevance to this motion is the value of the post-petition lease payments in which Union has a perfected security interest under the Carmi Stipulation. Both parties appear to agree that the values of the payments arising under Loans 2, 4, 5, 6, and 7 are less than the outstanding balance on those loans; in any event, no further data has been provided by either party for those loans. Each party has, however, submitted conflicting data on the remaining five loans. The data in Table C is provided by the Trustee through the Pulver Affidavit:

TABLE C: TRUSTEE'S VALUATION OF POST-PETITION LEASE PROCEEDS

[14] Days elapsed as of the Petition Date.

Loan #	Balance Unpaid on Petition Date	Payments Collected Between 4/19/1996 and 11/30/1998[15]	Payments Expected to be Received After 11/30/1998	Servicing Fee
1	$7,600	$4,900	$0	$200
3	$7,100	$12,700	$0	$100
8	$591,100	$535,300	$28,700	$14,600
9	$647,300	$589,900	$39,100	$10,300
10	$1,349,100	$1,126,500	$111,200	$29,100

Union has submitted a significantly different set of figures for these loans in the W. O'Neil Affidavit. In general, the W. O'Neil Affidavit shows minor discrepancies (which are not explained) in terms of the outstanding balance of the loans, and gives much higher figures for the value of the post-petition lease payments. This last difference appears to be due in large part to a difference in methodology: while the Trustee has calculated the value of these lease payments based on historical post-petition data, Union has attempted to calculate their hypothetical future value as of the Petition Date. In particular, Union appears to value every loan not 60 days delinquent as of the Petition Date as if it were 100% collectible for its entire term, without regard to whether such loan actually performed according to the model. As support for this method of valuation, Union relies on the Arcy Affidavit, which was originally submitted by the Trustee in connection with a lift-stay motion brought by the First State Bank of Wabasha ("Wabasha"). Union calls the Court's attention to ¶ 15 of that affidavit, which defines as "performing"– and

[15] Excludes the post-petition payments on leases to which the Trustee has asserted an objection pursuant to the Carmi Stipulation.

hence as fully collectable– any lease whose payments are less than 60 days in arrears. Applying this standard to Loans 1, 3, 8, 9, and 10, Union has calculated the following values for its security interests under each loan as of the Petition Date:

TABLE D: UNION'S VALUATION OF POST-PETITION LEASE PROCEEDS

Loan #	**Amount Owing on Petition Date**[16]	**Total Future Payments Due on all Leases Less Than 60 Days Overdue as of 3/29/1996**	**Amount of Union's Claim Alleged to be Unsecured as of 3/29/1996**
1	$10,977.00	$74,239.00	$0.00
3	$12,770.00	$28,235.00	$0.00
8	$573,409.00	$622,476.00	$0.00
9	$647,312.00	$739,479.00	$0.00
10	$1,296,788.00	$1,347,773.00	$0.00

The Trustee's valuation of the lease proceeds is limited to the historical, actual-performance analysis of the Pulver Affidavit; unlike Union, he does not present any evidence of the expected future value of these payments as of the Petition Date. Conversely, Union has not submitted any contrary evidence as to the leases' actual post-petition performance, nor has it submitted any evidence or expert opinion indicating that the valuation methodology used by Arcy for the Wabasha litigation is necessarily applicable to its own case.

DISCUSSION

[16] There are several discrepancies (not attributable to rounding) between the "balances unpaid on the petition date" reported by the Trustee and the "amounts owing on the petition date" reported by Union. The source of these discrepancies is not explained in either party's papers.

A. Cross-Motion for a Stay of Union's Summary Judgment Motion

As a preliminary matter, the Court considers the Trustee's argument that the stay imposed on the Trade Vendor litigation should be extended to the present motion. In his amended cross-motion,[17] the Trustee appears to base this request on two related grounds. First, the Trustee asserts that litigation of his preference claims against Union will ultimately require an evidentiary hearing on the existence of the Ponzi scheme, as will his preference claims against the Trade Vendors, and that to allow multiple hearings on a single factual issue to proceed separately would disserve the interests of uniformity and judicial efficiency. Second, the Trustee notes that both the Union litigation and the Trade Vendor litigation implicitly raise issues of whether and to what extent the Code § 547(c)(2) "ordinary course of business" affirmative defense would be available if the Debtors were proved to have operated a Ponzi scheme. Because the Trade Vendor litigation has been stayed in part to prepare for consolidated litigation of this issue, the Trustee argues that the rationale of this stay should apply with equal force to Union.

Were the Court presently preparing to hold an evidentiary hearing on the preference counterclaims, the Trustee's first point would merit careful consideration. However, this argument is simply premature on a motion for summary judgment, particularly in light of the fact that Union has not yet challenged the Trustee's factual allegations of a Ponzi scheme. Instead, by bringing this motion for summary judgment, Union has argued that the very existence or nonexistence of the Ponzi scheme is simply irrelevant to its own preference liability. While the need to avoid duplicative "Ponzi trials" may well justify some kind of a stay at a later stage of

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[17] The Trustee does not discuss his cross-motion in any of the memoranda of law submitted in connection with this matter.

this litigation, it does not and should not prevent the Court from first considering that trial's potential relevance with respect to a particular defendant.

The Trustee's second argument raises a different set of concerns. For the vast majority of the Trade Vendors defendants, it is probable that the outcome of their adversary proceedings will hinge on whether this Court adopts a *per se* rule under which the Code § 547(c)(2) is unavailable against a Ponzi debtor. *Compare Danning v. Bozek (In re Bullion Reserve of North America)*, 836 F.2d 1214, 1219 (9th Cir. 1988) (holding that Code § 547(c)(2) is not a defense to a preference action where the transfer was made by a "fraudulent business"); *Sender v. Heggland Family Trust (In re Hedged-Investments Associates, Inc.)*, 48 F.3d 470, 476 (10th Cir. 1995) (rejecting bright-line rule and holding that "non-investor" creditors may rely on an ordinary course of business defense notwithstanding the existence of a Ponzi scheme). Because of the relatively fact-independent nature and wide-ranging impact of this issue, the Court determined that it would attempt to address it through a single consolidated proceeding, at which time all Trade Vendor defendants would be afforded an opportunity to appear and be heard.

Although Union bases its summary judgment argument in part on the *Hedged-Investments* rationale, the Court does not believe that allowing this motion to go forward would necessarily frustrate the purpose of the Trade Vendor stay. First, as discussed at greater length below, the Court finds that the Code § 547(c)(2) portion of Union's summary judgment motion may be disposed of without reaching the general legal question posed by *Bullion Reserve* and *Hedged-Investments*. Second, even if this issue were to be decided, it would not necessarily have a prejudicial effect on the rights of the absent Trade Vendors. While it has been assumed so far that the Trade Vendors are similarly situated in relation to each other, there remains an open

question as to whether their status is truly comparable to that of banks such as Union. The Trustee appears to recognize this in his own memorandum of law, which asserts that Union would not be protected by the *Hedged-Investments* doctrine even if that holding was adopted as the law of this case. As such, the Court finds that there is little danger of unfair prejudice to absent parties if this motion is allowed to go forward, and the Trustee's cross-motion seeking a stay of Union's motion for partial summary judgment will be denied.

B. Union's Motion for Partial Summary Judgment on the Trustee's Preference Claims

Under Rule 56(c) of the Federal Rules of Civil Procedure, which is incorporated by reference into Fed.R.Bankr.P. 7056, a motion for summary judgment shall be granted if the moving party is able to establish that there is no genuine issue as to any material fact and that it is entitled to judgment as a matter of law. *See Celotex Corp. v. Catrett*, 477 U.S. 317, 322, 106 S.Ct. 2548, 2552, 91 L.Ed.2d 265 (1986). As discussed above, the Court finds that the Trustee's evidentiary submissions are sufficient to raise a genuine issue with respect to each of the disputed facts. It next remains for the Court to consider whether these issues of fact are material to the Trustee's causes of action.

As noted, the Trustee seeks to recover all payments made to Union within ninety days of the Petition Date pursuant to Code § 547. Under the terms of that section, a transfer may be avoided as a preference if each of five conditions is satisfied and none of seven exceptions are applicable. *See Union Bank v. Wolas*, 502 U.S. 151, 154, 112 S.Ct. 527, 529, 116 L.Ed.2d 514. The conditions, which are set out in Code § 547(b), are that the transfer must have been made: (1) for the benefit of a creditor; (2) on account of an antecedent debt; (3) while the debtor was

insolvent; and (4) within ninety days before bankruptcy; and (5) it must have enabled the transferee to receive a larger share of the estate's assets than it would have received if the transfer had not been made and the estate's assets had been liquidated under Chapter 7. *Id.* As the counterclaim plaintiff in this avoidance action, the Trustee bears the burden of proof on each of these elements by a preponderance of the evidence standard. *See Lawson v. Ford Motor Co. (In re Roblin Industries, Inc.)*, 78 F.3d 30, 34 (2d Cir. 1996).

The seven exceptions, which are set out in Code § 547(c), are affirmative defenses which must be asserted and proved by the transferee-defendant. *Id.* at 39. The only one of these defenses on which Union relies is Code § 547(c)(2), which provides that a transfer made pursuant to an antecedent debt will not be avoidable under Code § 547 if (1) the debt was incurred in the ordinary course of business of the debtor and the transferee; (2) the debt was repaid in the ordinary course of business of both the debtor and the transferee; and (3) the transfer was made according to ordinary business terms. *Id.* at 38.

It is apparent that if the Trustee is able to prove each of the disputed facts at trial, the first four conditions of Code § 547(b) will be met. Union argues, however, that with respect to Loans 1, 3, 8, 9, and 10, the Trustee will under no circumstances be able to meet his burden of proof on the Code § 547(b)(5) element of his prima facie case, on the theory that those pre-petition payments gave Union no more than what it would have been entitled to under a Chapter 7 liquidation. Alternately, Union argues that notwithstanding the allegations of the Debtors' fraud, it is entitled to summary judgment on the basis of its Code § 547(c)(2) defense with respect to the payments made under all ten loans.

1. Chapter 7 Liquidation Analysis – Code § 547(b)(5)

The preferential transfer provisions of Code § 547 are designed to further the Code's "central policy" of equality among creditors. *See Begier v. I.R.S.,* 496 U.S. 53, 58, 110 S.Ct. 2258, 2262, 110 L.Ed.2d 46 (1990). In practice, this policy acts both as a source of and as a limitation to the Trustee's avoidance power. While the Trustee is given a broad-ranging power to undo last-minute transactions that frustrate the Code's goal of a pro rata division among creditors, transfers that have no real distributional consequences are entirely beyond the purview of preference law. *See Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 229, 56 S.Ct. 450, 451, 80 L.Ed. 655 (1936) (construing § 60b of the 1898 Bankruptcy Act).

The modern version of the *Palmer Clay Products* doctrine is set out in Code § 547(b)(5), which limits the bankruptcy trustee's preference avoidance power to those transfers which improve the creditor-transferee's ultimate payoff relative to the payoff he would have received if the transfer had never been made and the creditor was forced to pursue his rights through a Chapter 7 liquidation.[18] In practice, this "hypothetical liquidation" test can often be reduced to

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[18] In full, this section provides that:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property– . . .
>
> . . . (5) that enables such creditor to receive more than such creditor would receive if–
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

a single, simple inquiry: if, instead of payment, the creditor had received a bankruptcy claim for the same amount and pursuant to the same debt, would that claim have been paid off in full? If so, there is no preference. This is because the creditor ultimately does no better as a result of the payment than he would have done without it, and the other creditors are consequently no worse off. If, on the other hand, the hypothetical claim would not have been paid in full, the transfer as a matter of law will have had the effect of improving the transferee's position at the expense of the general creditor body, since whatever surplus value is realized by the transferee comes at the expense of reducing the pool of assets available to the general unsecured creditors. This is precisely the type of inequality that Code § 547 was designed to prevent, and as a result, such a payment is potentially avoidable as a preferential transfer. *See Elliott v. Frontier Properties/ LP (In re Lewis W. Shurtleff, Inc.)*, 778 F.2d 1416, 1421 (9th Cir. 1985).

In the present case, it is apparently undisputed that the liabilities of the Consolidated Estate vastly exceed its assets, and that the general unsecured creditors will not receive full payment on their claims. At the same time, by virtue of the Carmi Stipulation, Union's claims against the Estate are at least partially secured by valuable collateral in the form of the Trustee's post-petition lease collections.[19] Given these conditions, there are two (and only two) possible scenarios under which the pre-petition payments to Union would be non-preferential under the liquidation test of Code § 547(b)(5). First, if the value which Union can expect to realize on its

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[19] The true value of Union's security interest may, of course, consist of the value of the leases and the underlying equipment as well as the lease proceeds. However, it appears that the collateral value of many of these leases is by now worthless, as most or all outstanding payments arising under them have already been collected by the Trustee. Because neither party has submitted evidence as to the present value of the equipment, the Court will assume for purposes of this motion that it is also of inconsequential value.

collateral exceeds the sum of its current claim against the Estate and the additional hypothetical claim which it would have been able to assert in the absence of the payments, the payments cannot be preferential. In such a case, Union would be fully secured on its claim, and would receive payment in full regardless of whether the allegedly preferential payments were made. *See Ray v. City Bank and Trust Co. (In re C-L Carthage Co., Inc.)*, 899 F.2d 1490, 1493 (6th Cir. 1990). Alternately, there can be no preference if, prior to the time the payments were made to Union, the cash proceeds became subject to Union's perfected security interest– provided, of course, that such security interest was itself immune from avoidance. Even if Union was less than fully secured on its claim as a whole, the payments under these circumstances would merely operate as the surrender of collateral to a lienholder. Since a lienholder is generally able to recover the value of its collateral in a liquidation, such payments would not have the effect of improving Union's position relative to its Chapter 7 rights, and they similarly would have no effect on the rights or recoveries of other creditors.[20] *See Danning v. World Airways, Inc. (In the Matter of Holiday Airlines Corp.)*, 647 F.2d 977, 978 (9th Cir. 1981); *Cedar Rapids Meats, Inc. v. Hager (In re Cedar Rapids Meats, Inc.)*, 121 B.R. 562, 572-73 (Bankr. N.D. Iowa 1990). As the party which carries the burden of proof under Code § 547(b)(5), the Trustee must accordingly prove that neither of these conditions were in place.

(i) Union's Interest in the Pre-Petition Payments

[20] In its supporting memoranda of law, Union argues that its alleged perfected security interest in the pre-petition cash proceeds will prevent the Trustee from meeting his Code § 547(b)(5) burden only with respect to loans 1, 3, 8, 9, and 10, loans for which Union is either fully secured or slightly undersecured. However, this argument would apply with equal force to any of the loan transactions, regardless of the degree to which Union is otherwise undersecured.

Union has submitted virtually no new evidence in support of its contention that it held a perfected security interest in the pre-petition payments, and instead relies almost exclusively on the Court's findings of fact and conclusions of law in the Carmi Decision. In pertinent part, that decision held that the lease collections were "proceeds" for purposes of the UCC, and that the banks generally held perfected security interests in the leases, as a result of their properly-filed financing statements and/or their actual possession of the ink-signed originals. *See* Carmi Decision at 42-43. However, the Court rejected the banks' suggestion that the right to receive lease payments was legally equivalent to the lease payments themselves, so that a perfected security interest in the one would necessarily entail a perfected security interest in the other. *Id*. at 44. Instead, the Court held that the banks' security interests in the actual lease payments could be perfected only to the extent that the banks complied with the terms of UCC § 9-306, which govern a secured party's rights to the proceeds of its collateral. *Id*. at 43. With respect to the post-petition, post-segregation order collections at issue in the Carmi Decision, the Court concluded that this test had been met. *Id.* at 86.

Unlike the present motion, the Carmi Decision did not address the question of perfection in proceeds which were received prior to the segregation order, an issue which is consequently not among the "common issues" that are binding on the Trustee. *See* Carmi Stipulation at ¶ 2. At the same time, many of the preliminary issues relevant to a discussion of perfection in pre-petition collections– including the perfection of the banks' security interest in the underlying leases and the applicability of UCC § 9-306– were decided as common issues, and as such are binding on the parties to this motion. While Union's exact argument on this point is not stated with the greatest of clarity, it appears to suggest that the conclusion that it was perfected in the

pre-petition payments should follow as an automatic consequence of the Court's holdings regarding the post-segregation payments.

Unfortunately for Union, this line of argument overlooks a critical difference between the pre-petition lease payments, which are at issue here, and the post-segregation payments which were at issue in the Carmi Decision. In the Carmi Decision, the question of whether the post-segregation lease proceeds were identifiable was never in dispute-- nor could it have been in dispute, as segregated funds are conclusively presumed to be identifiable at all times. *See In the Matter of the Ann Arbor Railroad Co.*, 414 F.Supp. 812, 823 (E.D. Mich. 1976). No such presumption is available with respect to the pre-petition collections.[21] Instead, by alleging that the pre-petition lease proceeds passed through the "Honeypot" account prior to their receipt by the banks, the Trustee has raised a genuine factual issue about whether, and to what extent, those proceeds were commingled.

This allegation of commingling (which must be presumed true for purposes of Union's summary judgement motion) is significant because of UCC § 9-306(2), which provides that "a security interest continues . . . in any identifiable proceeds including collections received by the debtor." While this section makes no mention of unidentifiable proceeds, courts have generally read into it an implied negative: that is, that the security interest does not continue in proceeds which are not identifiable. *See Unsecured Creditors Committee v. Marepcon Financial Corp (In re Bumper Sales, Inc.)*, 907 F.2d 1430, 1437 (4th Cir. 1990); *In re Pelton*, 171 B.R. 641, 648

[21] The Court notes parenthetically that while it is undisputed that pre-petition payments were made between the Debtors and Union on account of the leases, there is no direct evidence of how much (if anything) the Debtors collected on Union's leases from the end-users during that time, apart from Union's undocumented assertion that certain of the leases were less than sixty days overdue.

(Bankr. W.D. Wis. 1994); *Farmers & Merchants National Bank v. Sooner Cooperative, Inc.*, 7 U.C.C.Rep.Serv.2d 321, 327 (Okla. 1988); *General Motors Acceptance Corp. v. Norstar Bank*, 141 Misc.2d 349, 351, 532 N.Y.S.2d 685, 686 (N.Y.Sup.Ct. 1988).

In the opinion of Professor Gilmore, one of the principal authors of Article 9, any act of commingling would render cash proceeds permanently unidentifiable. As a result, a secured creditor would lose any right to the proceeds of his collateral the instant the debtor was allowed to place those proceeds in a general account. 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 27.4 (1965). Virtually all courts have rejected this sweeping rule, however, instead holding that a security interest might nevertheless continue in commingled funds if the creditor's share of those funds can be identified through common law "tracing" doctrines. *See Brown & Williamson Tobacco Corp. v. First National, Bank of Blue Island*, 504 F.2d 998, 1002 (7th Cir. 1974); *General Motors Acceptance Corp.*, 141 Misc.2d at 352.

A limited exception to this rule arises where the debtor has entered an insolvency proceeding. As before, the cash proceeds must be "identifiable" in order to carry a continuing security interest, and must be traced in order to be identified. However, rather than determining whether the cash can be traced through traditional common law doctrines, courts are directed to apply a considerably narrower statutory tracing test set out by UCC § 9-306(4). *See Harley-Davidson Motor Co. v. Bank of New England-Old Colony*, 897 F.2d 611, 621 (1st Cir. 1990). In full, that section provides that:

> In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:
>
> > (a) in identifiable non-cash proceeds and in separate deposit accounts containing only proceeds;

> (b) in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;
>
> (c) in identifiable cash proceeds in the form of checks and the like which are not deposited in a deposit account prior to the insolvency proceedings; and
>
> (d) in all cash and deposit accounts of the debtor, in which proceeds have been commingled with other funds, but the perfected security interest under this paragraph (d) is
>
> > (i) subject to any right of set-off, and
> >
> > (ii) limited to an amount not greater than the amount of any cash proceeds received by the debtor within ten days before the insolvency proceedings less the sum of (I) the payments to the secured party on account of cash proceeds received by the debtor during such period and (II) the cash proceeds received by the debtor during such period to which the secured party is entitled under paragraphs (a) through (c) of this subsection (4).

NYUCC § 9-306(4).

There exists a considerable body of case law examining the circumstances under which UCC § 9-306(4) becomes applicable. Although a plain reading of the statute might suggest that it applies to any transaction with an insolvent debtor, regardless of the point in time when the insolvency proceeding was actually commenced, most courts have held that it is effective only with respect to funds that were in the debtor's possession at the time of the insolvency proceeding. It has no relevance to funds that left the debtor's possession at an earlier date, nor is it relevant to commingling that might have taken place after the debtor entered the insolvency proceedings. *See Insley Manufacturing Corp. v. Draper Bank & Trust*, 1 UCC.Rep.Serv.2d 961, 969 (Utah 1986).

It is undisputed that the funds at issue were paid to Union (and thus left the Debtors' possession) prior to the Petition Date. Nevertheless, the Court believes that UCC § 9-306(4) is

directly applicable to the discussion of Union's security interest under Code § 547(b)(5). The reason for this is that Code § 547(b)(5) looks not to the real state of events that existed prior to the petition date, but instead to the hypothetical state of events that would have existed if the alleged preferential transfers had not been made. Even if it is assumed, for the sake of argument, that the payments made to Union could be traced back to collections made by the Debtors under Union's leases, the hypothetical undoing of the payments to Union would place these funds back in the possession of the Debtors as of the Petition Date. If, under this hypothetical scenario, Union had then tried to assert its security interest in those funds, it would have been able to do so only to the extent permitted by UCC § 9-306(4). As a result, it is to that section that the Court must turn in determining whether the allegedly preferential transfers had the effect of increasing Union's eventual recovery.

It is clear that by alleging that the lease payments became commingled with other funds while in the Debtors' possession, the Trustee has raised material facts sufficient to defeat Union's claims of perfection under subsections (a), (b), and (c) of UCC § 9-306(4). The analysis is considerably more complicated, however, under subsection (d), which eliminates the tracing requirement altogether for commingled proceeds received within ten days of the Petition Date. Stated differently, this section creates a conclusive presumption that any cash collateral paid into the Honeypot within those ten days remained in the Honeypot on the Petition Date. This presumption remains in force even if conventional tracing is impossible. *See United Jersey Bank/ Central N.A. v. Collated Products Corp. (In re Collated Products Corp.)*, 121 B.R. 195, 206 (D. Del. 1990); 4 JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 32-9, at 297 (4th ed. 1995). Under some circumstances, then, UCC § 9-306(4)(d)(ii) might

operate to give Union at least a partial security interest in the pre-petition collections notwithstanding the alleged commingling of funds in the Honeypot. Such a security interest, however, would be at most limited to the amount of lease collections received by the Debtors that were (1) made pursuant to leases in which Union had a perfected security interest, *see* UCC § 9-306(3); and (2) received by the Debtors between March 19, 1996, and March 29, 1996.

The record before the Court is clearly insufficient to grant Union even partial summary judgment on this basis. Nothing in the affidavit submitted by Union gives any indication of when particular lease collections were received by the Debtors, and the Court accordingly has no basis to conclude that any proceeds whatsoever were in fact received by the Debtors on account of Union's leases between March 19 and March 29, 1996. While the Trustee will ultimately bear the burden of proof under Code § 547(b)(5),[22] the initial burden of production on all issues relevant to this summary judgment motion lies with Union. *See F.D.I.C. v. Giammettei*, 34 F.3d 51, 55 (2d Cir. 1994). As this burden of production has not been met with respect to the factual issues arising under UCC § 9-306, the Court finds that there remains a genuine issue of material fact with regard to Union's security interest in any pre-petition lease collections, and that Union is accordingly not entitled to summary judgment on this basis.

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[22] There is some authority, however, for the proposition that a creditor always bears the burden of proving that the proceeds of its collateral can be identified, even where the identification issue arises as part of an element for which the burden of proof is otherwise on the creditor's opponent. *See Stoumbos v. Kilimnik*, 988 F.2d 949, 957 (9th Cir. 1993); *Howarth v. Universal C.I.T. Credit Corp.*, 203 F.Supp. 279, 282 (W.D. Penn. 1962). Because Union, as the movant for summary judgment, has in either case failed to meet its initial burden of production on this issue, the Court finds it unnecessary at this time to decide the eventual burden of proof under UCC § 9-306(4).

(ii) Value of Union's Post-Petition Collateral in a Hypothetical Chapter 7 Liquidation

Even if it were determined that the pre-petition payments to Union were not a return of collateral, Union would be entitled to summary judgment under Code § 547(b)(5) if the value of its security interest in the post-petition collections is large enough to make its claims as a whole fully secured. As a preliminary matter, there is apparent agreement that Loans 1 through 10 were not cross-collateralized. As a result, the secured status of Union must be determined not in the aggregate, but rather with respect to each loan and its collateral separately.[23]

The different valuations proposed by Union and the Trustee for these post-petition collections appear to arise out of three differences in methodology. First, while the Trustee measures the value of the leases according to their actual post-petition collection history, Union values them according to what their expected future value might have been on the Petition Date. Secondly, while the Trustee's valuation includes a deduction for the servicing expenses that will be charged to Union under the terms of the Carmi Stipulation, Union's valuation does not. Finally, Union asserts that the value of its security interest should include an "add back" equal to the amount of collateral given up by the Debtors as a result of the allegedly preferential transfers.

Regarding the first of these issues, the Court has previously held– as has nearly every other bankruptcy court that has ruled on the matter– that the proper time for valuing a creditor's collateral for a Code § 547(b)(5) analysis is the Petition Date, not the date of the preference trial.

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[23] As noted above, Union concedes that it was not fully secured on Loans 2, 4, 5, 6, or 7.

See In re Hobaica, 77 B.R.392, 394 (Bankr. N.D.N.Y. 1987); *Neuger v. United States (In re Tenna Corp.)*, 801 F.2d 819, 823 (6th Cir. 1986); *Gray v. A.I. Credit Corp. (In re Paris Industries Corp.)*, 130 B.R. 1 (Bankr. D. Me. 1991) (citing cases). Indeed, any other outcome would be grossly unfair to secured creditors such as Union. In addition to forcing a creditor to bear the risk of a decline in the value of collateral over which it might have no control, the trial date standard can often place a creditor at a severe tactical disadvantage in its litigation with the debtor or trustee. As the Sixth Circuit noted,

> The bankruptcy court stated that it was "inconceivable and illogical" to construct a hypothetical Chapter 7 liquidation as of the date the petition was filed in this case. We believe that it is "inconceivable and illogical" to assume that Congress intended to permit the estate's trustee to control the timing for testing whether a payment can be avoided as a preference. . . . If the trustee had commenced the adversary proceeding and the hearing was held soon thereafter, the ratio of debts to assets of the estate at that time might have been dramatically different. We agree with the government that such a reading of the Code invites manipulation and that, we must assume, was not Congress' intent.

In re Tenna Corp., 801 F.2d at 823.

However, while the Court approves of at least this much of Union's valuation, it finds little relevance in the actual data offered by the W. O'Neil Affidavit. These figures, it should be noted, are based entirely on Union's application of a valuation algorithm purportedly used by Arcy, whose affidavit states that "Accounts Receivable less than 60 days in arrears are considered to be 100% collectible."[24] (Arcy Aff. at ¶ 13). By its own terms, however, the Arcy Affidavit is not necessarily applicable to an analysis of the Union leases. In the first place, Arcy's findings

[24] The Arcy Affidavit also assumed a lower, but non-zero, collection rate for leases more than sixty days overdue. Union does not rely on these collections in its proposed Petition Date valuation.

pertained to a specific set of leases claimed by a single financial institution (First State Bank of Wabasha); his affidavit nowhere asserts that the accounting methods used would be appropriate for other lenders or other leases. Secondly, the conclusions of the Arcy Affidavit are expressly conditioned on a number of factual findings which may not be applicable to the present adversary proceeding. In addition to performing an individualized inspection of the payment history of certain Wabasha leases (which he does not seem to have done for Union), Arcy noted that a discount would have to be applied to any estimate of the future value of the lease payments. As explained in his affidavit,

> Essentially, finance professionals can have at least two different perspectives on the valuation of an asset held by its owner. One is to determine what the asset would sell for in a transaction on the open market (the "Market Value"). The other is to determine the value of the asset assuming that the owner continues to hold the asset and enjoy the benefits of ownership (the "In-Place Value"). The Market Value and the In-Place Value of an asset that consists primarily of expected future payments, such as the Collateral Leases, differ primarily because a different discount rate is applied in a Market Valuation than is applied in an In-Place Valuation.

(Arcy Aff. at ¶ 18).

Arcy further determined that, since the Estate was likely to continue servicing the Wabasha leases for the remainder of their term, the In-Place Valuation discount would be the most accurate measure of the value to the Estate of those leases. There is nothing on the record, however, which indicates that this same discount would have been appropriate had the assets of the Estate been liquidated on March 29, 1996.[25]

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[25] In addition, Union's adaptation of this analysis appears to apply a zero-discount rate to the expected future lease collections. Arcy does not identify any circumstance under which such a discount would be appropriate.

This lack of relevant evidence from Union does not end the Court's Code § 547(b)(5) analysis. While the Pulver Affidavit is flawed in that it adopts an incorrect date of valuation, the Court believes that these figures may nevertheless serve as a baseline from which to measure Union's Petition Date security interests. Until and unless evidence is presented to the contrary, the Court will assume that there would be no difference between a predicted and a historical valuation of the leases from the Petition Date; stated differently, the existence of credible historical data from the Pulver Affidavit creates a rebuttable presumption that similar returns would have been predicted under a future-value analysis performed on March 29, 1996. Since all disputed facts are to be construed in the Trustee's favor for this summary judgment motion, the Court will accordingly use the Pulver figures in the remainder of its analysis.

The second point of contention involves the Trustee's deduction of servicing expenses from the value of the collateral lease payments in the Pulver Affidavit. Although the cost of administering (or in this case, collecting) collateral may be properly deducted from the value of a creditor's security interest for purposes of Code § 547(b)(5), *see In re Hobaica*, 77 B.R. at 394, Union argues that in this case, the Trustee "has already deducted all lease servicing fees from the payments already made under the Carmi Decision." (Union Supp. Mem. at 15). The Court fails to understand the relevance of this point. As noted above, the value of Union's collateral for Code § 547(b)(5) purposes is the value that the collateral held on the Petition Date, not the value of whatever part of the collateral still remains in the Trustee's possession. The fact that Union may have already paid some of these post-petition servicing costs (presumably through deductions on payments due to it under the Carmi Stipulation) does not and cannot enter into the analysis.

Finally, Union argues that the value of the allegedly preferential payments should be "added back" to the value of its security interest for purposes of the Code § 547(b)(5) analysis, apparently on the theory that the pre-petition transfers removed funds that would have otherwise remained in the Debtors' possession and formed part of Union's secured collateral. This argument is premised on the idea that Union held at least some perfected security interest in the pre-petition lease collections. For reasons explained above, the Court cannot reach such a conclusion on the record presently before it. As such, the Court will not consider the bank's add-back theory in this motion.

Based on the foregoing analysis, the Court will accept as true for purposes of this motion the figures for Loans 1, 3, 8, 9, and 10 reported in Figure E, below. The "Hypothetical Claim Amount" is taken by adding together the Petition Date Balance and all payments made to Union during the ninety days preceding the Petition Date, since any payments not made (for purposes of the hypothetical liquidation) would serve to increase Union's claim against the Estate. The "Maximum Amount by which Union would be Unsecured" refers to the amount of the unsecured claim under each loan which Union would have asserted if the allegedly preferential payments had not been made. This is calculated by subtracting from the Hypothetical Claim Amount the minimum value of the post-petition collateral (according to Pulver) and the total servicing fees which the Trustee may deduct from the collateral under the terms of the Carmi Stipulation.

TABLE E: ANALYSIS OF UNION'S SECURITY INTERESTS UNDER HYPOTHETICAL LIQUIDATION

Loan #	Balance Unpaid on Petition Date	Amount of Allegedly Preferential Payments	Hypothetical Claim Amount	Petition Date Value of Future Lease Proceeds	Total Servicing Fees	Amount by which Union is Allegedly Unsecured

1	$7,600	$4,616.37	$12,216.37	$4,900	$200	$7,516.37
3	$7,100	$4,872	$11,972	$12,700	$100	$0
8	$591,100	$82,453.23	$673,553.23	$564,000	$14,600	$124,153.23
9	$647,300	$77,640.10	$724,940.10	$629,000	$10,300	$106,240.10
10	$1,349,100	$107,766.10	$1,456,866.10	$1,237,700	$29,100	$248,266.10

Under these figures, Union would have been fully secured on Loan 3 even if the pre-petition payments had never been made; as such, any pre-petition payments pursuant to this loan would not have allowed Union to increase its recovery under Chapter 7 liquidation, and are not preferences for purposes of Code § 547. If the Trustee is able to prove the data from the Pulver Affidavit, however, it would follow that all other pre-petition payments which the Trustee seeks to avoid had the effect of reducing the unsecured portion of Union's claim against the Estate.[26] In such a case, the Trustee's burden under Code § 547(b)(5) would be satisfied, as the payments would have improved Union's recovery at the expense of other creditors in a Chapter 7 liquidation. *In re Lewis W. Shurtleff, Inc.*, 778 F.2d at 1421. Based on the foregoing, Union is entitled to summary judgment on the Third Counterclaim, but is not entitled to summary

[26] In its supporting papers, Union argues at considerable length that if the amount of the preferential payment exceeded the amount by which it was unsecured, the Trustee's recovery should be correspondingly reduced. Because the Court cannot conclude that any of the surviving causes of action present such a circumstance, it is unnecessary to consider this argument at the present time.

judgment on any of the other counterclaims by reason of Code § 547(b)(5).

Ordinary Course of Business Defense -- Code § 547(c)(2)

Union alternately seeks summary judgment with respect to all ten counterclaims based on the "ordinary course of business" affirmative defense of Code § 547(a)(2). In pertinent part, that section provides that the Trustee may not avoid a preferential transfer if it is proved that the transfer was in payment of an antecedent debt which was both incurred and repaid "in the ordinary course of business or financial affairs of the debtor and the transferee," *see* Code § 547(a)(2)(A, B), and which was also "made according to ordinary business terms," *see* Code § 547(a)(2)(C).

Noting that the apparent purpose of this subsection is to protect ordinary trade vendors who extend short-term credit to business debtors, many courts initially expressed doubt about whether the ordinary course of business defense is even available in long-term transactions such as those between Union and the Debtors. *See CHG International Inc. v. Barclays Bank (In the Matter of CHG International, Inc.)*, 897 F.2d 1479, 1485 (9th Cir. 1990). This question was eventually answered in the affirmative by the Supreme Court, which examined the structure and plain meaning of Code § 547(c)(2) and concluded that "payments on long-term debt, as well as payments on short-term debt, may qualify for the ordinary course of business exception to the trustee's power to avoid preferential transfers." *Wolas*, 502 U.S. at 162.

In its supporting papers, Union appears to take the *Wolas* holding one step further, suggesting that "as a matter of law it is the ordinary course of business in the banking industry for banks to receive the payments due on loans they have extended to their customers, and . . .

as a matter of law it is the ordinary course of business for companies in the office equipment business to borrow funds from banks and make the payments due on those loans." (Union Reply Mem. at ¶ 21). This interpretation of Code § 547(c)(2) can hardly be reconciled with the language of *Wolas*, which held only that long-term debt payments "may qualify" for the defense, not that they automatically did qualify. *Wolas*, 502 U.S. at 162. Moreover, the *Wolas* Court concluded its decision by remanding the case to the lower court for a determination of whether the loan transactions between the bank and the debtor met the "ordinary course" standard, even though it was apparently undisputed that the transferee in that case was a commercial lender and that the payment at issue was made pursuant to a business loan. *Id.* at 151. *See also Matter of P.A. Bergner & Co.*, 140 F.3d 1111 (7th Cir. 1998) (holding that loan repayment to a commercial lender was not in the ordinary course of the lender's business). Yet apart from its self-description as a "commercial lender," Union has come forward with no affirmative evidence of what constitutes the "ordinary course of business" for the debtor or for itself.

Even if Union had presented evidence that the loans were incurred and received in the ordinary course of business, it would still have to come forward with evidence showing that its transactions with the Debtors were made according to ordinary business terms under Code § 547(c)(2)(C). The burden which a defendant must meet in order to obtain summary judgment under this section was discussed at considerable length by the Second Circuit in *Roblin Industries*. At a minimum, this burden requires that the creditor "demonstrate that the terms of a payment for which it seeks the protection of the ordinary course of business exception fall within the bounds of ordinary practice of others similarly situated." *Roblin Industries*, 78 F.3d at 41. The court further noted that while evidence of "unusual action" by the debtor did not

automatically remove the transaction from Code § 547(c)(2) protection, the creditor-defendant would at the very least bear the burden of proving that any apparent irregularities were in fact acceptable under industry custom. *Id.* at 42. Thus, the Court quoted with approval a Seventh Circuit decision in which it was held that evidence of late payments by the debtor could cause the transferee to lose its ordinary business terms defense, unless it could be shown that such late payments fell "within the outer limits of normal industry practices." *See In the Matter of Tolona Pizza Products Corp.*, 3 F.3d 1029, 1032 (7th Cir. 1993). While not directly addressed by the *Roblin Industries* court, proof of illegal conduct by the debtor would presumably raise the creditor's evidentiary hurdle under this section even higher. In such a case, it would be imperative for the creditor to come forward with evidence that it was "common industry practice" to enter into such transactions without regard for the other party's illegal conduct, or at the very least that its failure to detect the illegality did not result from a deviation from standard industry procedures. *See Milwaukee Cheese Wisconsin, Inc. v. Bukowski (In re Milwaukee Cheese Wisconsin, Inc.)*, 164 B.R. 297, 308 (Bankr. E.D. Wisc. 1993).

It is obvious that under all three prongs of the Code § 547(c)(2) test, the sparse evidence offered by Union falls far short of what would be required to support a viable summary judgment motion. Union has submitted no evidence that the type of loan transaction it entered into with the Debtors was normal by any objective industry standard. It has not offered any evidence of the business practices of either itself or the Debtors outside of the transactions at issue. It has not offered any evidence indicating that the sporadic repayment practices outlined in the Szlosek Affidavit would be considered reasonable in its industry. Most importantly, it has offered no evidence that its transactions with the Debtors would have fallen within the bounds of accepted

industry practice, notwithstanding the alleged fraud perpetrated by the Debtors. As a result, the record as presently developed does not justify a granting of partial summary judgment to Union on the basis of its Code § 547(c)(2) defense.[27]

Based on the foregoing, Union's motion for summary judgment is hereby

GRANTED with respect to the Trustee's Third Counterclaim, which seeks to avoid payments made pursuant to the loan designated above as Loan 3; and

GRANTED in part with respect to the Trustee's Eleventh Counterclaim, to the extent that such counterclaim seeks the turnover of funds sought to be avoided under the Third Counterclaim; and

DENIED with respect to the Trustee's First, Second, Fourth, Fifth, Sixth, Seventh, Eighth, Ninth, and Tenth Counterclaims, as well as with respect to the remainder of the Eleventh Counterclaim; and it is further

ORDERED that the Trustee turn over to Union any and all funds which are currently being held back from the amounts due to Union under the Carmi Stipulation, to the extent that such holdback is attributable to the Trustee's Third Counterclaim; and it is further

ORDERED that the Trustee's cross-motion seeking a stay of the present adversary proceeding is denied without prejudice.

Dated at Utica, New York

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[27] In light of Union's failure to meet its burden of production on this summary judgment motion, it is not necessary for the Court to consider the Trustee's contention that the Code § 547(c)(2) defense is unavailable in cases involving Ponzi schemes.

this 1st day of July 1999

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STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge