UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

THE BENNETT FUNDING GROUP, INC.	CASE NO. 96-61376
BENNETT RECEIVABLES CORPORATION	96-61377
BENNETT RECEIVABLES CORPORATION II	96-61378
BENNETT MANAGEMENT AND DEVELOPMENT CORPORATION	96-61379
	Chapter 11
Debtors	Jointly Administered

APPEARANCES:

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

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

The Court considers herein a motion filed on April 24, 1996, by Manufacturers and Traders Trust Company (the "Bank") seeking relief from the automatic stay pursuant to §362(d)

of the Bankruptcy Code (11 U.S.C. §§101-1330) ("Code") in order to allow the Bank to setoff monies on deposit with the Bank against certain obligations of The Bennett Funding Group, Inc. ("BFG"), the debtor in the case herein.[1]

The motion was originally heard in Utica, New York, on April 9, 1996, and adjourned to June 13, 1996. The Court provided the parties with an opportunity to file memoranda of law by July 12, 1996. Other banks similarly situated were given until July 26, 1996, to file *amicus* briefs. The Trustee was afforded an additional opportunity to reply to the arguments of the various banks, and the matter was submitted for decision on August 5, 1996.

JURISDICTIONAL STATEMENT

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

FACTS

Prior to filing, BFG was in the business of originating, purchasing and selling commercial leases of copy machines and other office equipment. For purposes of obtaining monies from the Bank to finance its operations, various leases in which BFG was a lessor were compiled into

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[1]BFG, along with three other related corporate entities, filed voluntary petitions pursuant to Chapter 11 on March 29, 1996 ("Petition Date"). On April 18, 1996, Richard C.Breeden was appointed trustee ("Trustee") in all four cases by the Office of the U.S. Trustee pursuant to Code §1104 and said appointment was approved by this Court the same day. The Court approved the joint administration of the four cases on May 3, 1996.

portfolios or "packages" designed to provide for the repayment of principal and interest to the Bank.

The Bank alleges that it entered into six such financing transactions with BFG, beginning on June 19, 1991. As of the Petition Date, BFG allegedly remained obligated on only two "lease packages." *See* Reply Affidavit of Patrick J. Chambers, Vice President of the Bank, sworn to on July 3, 1996 ("Chambers' Affidavit"), at Footnote 1. These particular transactions occurred on October 25, 1991, and January 31, 1992. Pursuant to the terms of the Servicing Agreements executed in connection with the two transactions (*see* Exhibit "C" of Bank's motion), BFG collected the lease payments from the individual equipment lessees and remitted the monies to the Bank on a monthly basis. The Promissory Notes executed as part of the financing transactions included amortization schedules of the monthly obligations to be paid to the Bank (*see* Exhibit "E" of Bank's motion). Said payments were facilitated through the use of an Advance Payment Account ("Account") set up with the Bank in the name of BFG. BFG made monthly deposits to the Account as payments were received by it from the various lessees. In turn the Bank debited the Account on a monthly basis in the amounts set forth in the amortization schedules.[2] The balance owed to the Bank with respect to both transactions was $23,909.56 as of the Petition Date (*see* Bank's Memorandum of Law, filed July 12, 1996, p. 4).

According to the terms of the agreement ("Agreement") establishing the Account (*see* Exhibit "F" of Bank's motion), BFG pledged, assigned, transferred and granted to the Bank a

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[2]The initial deposit into the Account consisted of one month's advance payment which was deducted from the amount that was to have been paid to BFG by the Bank. The Account "functioned as a payment vehicle with respect to all of the packages." Chambers' Affidavit at Footnote 1.

security interest in and to the sum of one month's advance payments on the leases ("Collateral"). As of the Petition Date, BFG's monthly obligation on the two lease portfolios held by the Bank allegedly amounted to $2,061.72 on the October 25, 1991 transaction, payable April 24, 1996, and $657.66 on the January 31, 1992 transaction, payable on March 31, 1996, for a total monthly payment of $2,719.38 (*see* amortization schedules attached to Promissory Notes, Exhibit "E" of Bank's Motion). The balance in the Account as of the Petition Date was $53,691.75.[3]

Under the Agreement, the monies deposited by BFG into the Account were to be invested by the Bank and interest credited to BFG (*see* ¶6 of the Agreement). In addition, BFG was required to report and pay all income taxes on any interest earned on the Collateral in the Account (*see* ¶6 of the Agreement). BFG was authorized to withdraw any accrued interest or other monies in excess of the Bank's Collateral, specifically the amount of the next month's payments, once every three months (*see* ¶7 of the Agreement). Upon performance of all of its obligations under the terms and conditions of the various documents executed as part of the transactions[4], BFG was entitled to withdraw the remaining Collateral, including any accrued interest, from the Account (*see* ¶7 of the Agreement). Until such time, BFG was prohibited from assigning, withdrawing or selling any of its interests in the Collateral on deposit in the Account

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[3]According to Chambers' Affidavit, the average balance in the Account for the 12 months prior to the filing of BFG's Chapter 11 petition was $50,539.14. During the 90 day period prior to the Petition Date, the Bank allegedly had debited the Account in the amount of $11,365.03.

[4]The Bank has provided copies of the Assignments of Contracts with respect to the two packages which remain unpaid (Exhibit "A" of Bank's motion), as well as the UCC-1 financing statements (Exhibit "B" of Bank's motion), the Security Agreements (Exhibit "C" of the Bank's motion), Guarantees (Exhibit "D" of Bank's motion), Guarantee Collateral Agreements and Promissory notes (Exhibit "E" of Bank's motion) and the Payment Account Agreements (Exhibit "F" of Bank's motion).

(*see* ¶8 of the Agreement).

DISCUSSION

Code §362(a)(7) provides that the filing of a bankruptcy petition operates as a stay of "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." The Bank seeks to obtain relief from the automatic stay for cause pursuant to Code §362(d), alleging that no payments have been made on the Bank's claim by BFG since the Petition Date.[5]

A creditor's right to setoff is governed by Code §553, which requires that the creditor's debt to the debtor and the creditor's claim against the debtor both arise before the commencement of the case, and that the debts are mutual. *In re Sentinel Products Corp.*, 192 B.R. 41, 45 (N.D.N.Y. 1996); *In re Prudential Lines, Inc.*, 148 B.R. 730, 751 (Bankr. S.D.N.Y. 1992) (citations omitted), *aff'd in part, rev'd in part,* 170 B.R. 222 (S.D.N.Y. 1994), *appeal dismissed* 59 F.3d 327 (2d Cir. 1995). Code §553 simply preserves the rights that existed under applicable nonbankruptcy law on the Petition Date. *Citizens Bank of Maryland v. Strumpf*, 116 S.Ct. 286, 289, 133 L.Ed.2d 258 (1995); In re Chateaugay Corp*., 94 F.3d 772, 777 n.5 (2d Cir. 1996); Sentinel Products*, 192 B.R. at 45. "'[W]hether a setoff of existing obligations may be effected or sustained in bankruptcy depends upon the terms of section 553 [of the Bankruptcy Code], and not upon the terms of state laws or statutes." *Pereira v. United Jersey Bank*, 1996 WL 591275 at *10 (S.D.N.Y. Oct. 11, 1996), quoting 4 COLLIER ON BANKRUPTCY ¶553.06, at 553-39

[5]Trustee apparently does not dispute that the Bank has a valid claim against BFG.

(Lawrence P. King ed., 15th ed. 1996). According to the Agreement, the "applicable nonbankruptcy law" to be applied is that in effect where the Bank has its principal place of residence" (*see* ¶14 of the Agreement). In this case, the Bank is headquartered in New York State. New York recognizes both a common law and statutory right of setoff. *In re Westchester Structures, Inc.*, 181 B.R. 730, 740 (Bankr. S.D.N.Y. 1995). Under New York law the debts must be mutual. *Id.* Furthermore, under §151 of the New York Debtor and Creditor Law ("NYD&CL"), the debts can be matured or unmatured but they cannot be contingent. *Id.*

The Bank, as the party seeking setoff, has the burden of establishing that the debts are not contingent, that they arose prepetition, and that mutuality exists. *Id.* at 739; *In re Ionosphere Clubs, Inc.*, 164 B.R. 839, 841 (Bankr. S.D.N.Y. 1994) (citation omitted). In this case, the Bank has provided evidence that the documents memorializing the transactions with BFG, including the Promissory Notes, Guarantees, Guarantee Collateral Agreements and the Payment Account Agreements, were executed prepetition on October 25, 1991 and January 31, 1992, respectively. (Exhibits "E" and "F" of Bank's motion). The Promissory Notes represent debts of BFG which, although not due as of the Petition Date, were certainly owing. Therefore, although the debt was neither matured nor contingent on the Petition Date, the Bank's right of setoff "'must be regarded as manifestly present.'" *In re Kroh Bros. Development Co.*, 101 B.R. 114, 117 (Bankr. W.D.Mo. 1989), quoting *Matter of Isis Foods, Inc.*, 24 B.R. 75, 76 (Bankr.W.D.Mo. 1982).

With respect to the debt owed by the Bank to BFG, monies were initially deposited into the Account in 1991 by deducting the amount of the first month's payments to be paid by BFG upon receipt of the lease payments in the Bank's portfolio from the amount that the Bank was making available to BFG. That amount comprised the Bank's Collateral initially on deposit in

the Account pursuant to the terms of the Agreements.[6] Said Collateral was to be held by the Bank until it received full payment under the terms of the particular Promissory Note. As such, that portion of the Account represented a contingent debt owed by the Bank to BFG for which there is no right of setoff under NYD&CL §151. However, in addition to the Collateral, the Account includes monies deposited by BFG on a monthly basis prepetition and accrued interest, both of which BFG was entitled to withdraw every three months.

Trustee contends that the Account was established as a payment mechanism and that the monies were intended to be used to pay the Bank. As such Trustee argues that no "debt" was owed by the Bank to BFG prepetition. This argument, however, fails to recognize that a debt was created by virtue of the fact that BFG had a right to withdraw the interest payments, as well as any monies in excess of the Collateral from the Account on a quarterly basis. The fact that BFG, pursuant to the Agreement, elected to limit its right of withdrawal of monies from the Account does not, in the opinion of the Court, negate the existence of the Bank's prepetition "debt" to BFG for purposes of considering the Bank's right of setoff.

The question then arises whether the debts are mutual. Mutual debts are those due to and from the same parties in the same capacity. *Modern Settings, Inc. v. Prudential-Bache Securities, Inc.*, 936 F.2d 640, 648 (2d Cir. 1991) (citations omitted). An "essential element of mutuality inheres in the tension between the debtor-depositor's right to the use of the money on the one

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[6]Arguably, as subsequent financing transactions occurred between the parties, the amount of the Collateral in the Account fluctuated, depending on the status of the various lease packages and the respective obligations of both parties. Upon full payment of any single Promissory Note, the Bank was obligated to return the Collateral to BFG. At the same time as additional financing transactions occurred, the amount of the Collateral of necessity had to be increased to secure the first month's payments for any subsequent lease packages covered by other Promissory Notes and Agreements.

hand and the creditor's-bank's right to repayment on the other." *In re Savig*, 50 B.R. 1003, 1005 (D.C.Minn. 1985). Trustee asserts that the monies deposited by BFG constituted a "transfer or payment rather than a traditional deposit that would create a debtor-creditor relationship." *See* p.7 of Trustee's Reply Memorandum of Law, filed August 2, 1996.

"The general rule is that a deposit in a bank is presumed to be a general deposit . . . and the burden of proving that a deposit is for a special purpose is on the party seeking to establish it as a special deposit." *In re Amco Products, Inc., 17 B.R. 758,* 763 (Bankr. W.D.Mo. 1982), *rev'd on other grounds*, 50 B.R. 723 (W.D.Mo 1983). One factor to be considered is whether the Bank had a right to commingle the deposits made by BFG since "funds on general deposit in a bank become the property of the bank, and the legal effect of the deposit is to create a debtor-creditor relation between the depositor and the bank." *Id.* at 762 (citations omitted); *see also Strumpf*, 116 S.Ct. at 290 (stating that monies in a bank account do not belong to the depositor. The account "consists of nothing more or less than a promise to pay, from the bank to the depositor...").

A review of the Agreement reveals no requirement that the monies deposited into the Account by BFG be segregated and unavailable for use by the Bank. At the most the Account was a general deposit account established for the special purpose of providing a vehicle for payment to the Bank, but nonetheless it was still a general deposit account. That a debtor-creditor relationship exists between the Bank and BFG finds additional support in the fact that the Bank was required to pay interest on the monies deposited by BFG. *See In re Penn Central Transp. Co.,* 392 F.Supp. 960, 962 (E.D.Pa. 1975) (indicating that the presence of a provision for the payment of interest indicates the presence of a debtor-creditor relationship). However,

Trustee contends that since BFG's right to withdraw any interest, as well as any monies in excess of the following month's payment to the Bank, was limited to four times a year, no mutual obligation on the part of the Bank to make monies available to BFG upon demand existed.

In support of his argument, Trustee cites to *In re Savig*, a case in which the debtors deposited proceeds of sales of inventory and collections on receivables into a "collateral account" with the bank. *Savig*, 50 B.R. at 1004. The account was under the exclusive control of the bank which had loaned the debtors in excess of $350,000. Application of the monies in the account to reduce the indebtedness to the bank was at the discretion of the bank. *Id.* at 1005. In the event that the debtors required funds, they had to seek the consent of the bank. The bank was entitled to withhold its consent. In the event that the bank consented, it would transfer monies from the collateral account into the debtors' checking account with the bank. *Id.* The debtors did not have any right to withdraw any of the monies directly from the collateral account and "retained no discretion in the use of funds deposited in the collateral account." *Id.* at 1006. Although the debtors were entitled to any surplus in the collateral account once the indebtedness to the bank had been discharged, the court found that there was no mutuality based on this "hypothetical future interest" in the collateral account and concluded that the account "could never be the subject of a setoff of a mutual debt." *Id.*

As discussed above, this Court agrees with the findings in *Savig* that there is no mutuality insofar as the Collateral is concerned given that it is merely a hypothetical or contingent future interest. However, *Savig* is easily distinguished when one considers the non-Collateral nature of the balance of the monies in the Account. In *Savig* the "collateral account" was comprised **only** of the bank's collateral, namely the debtors' inventory sales proceeds and receivable

collections. The debtors had no right whatsoever to withdraw any of the monies therefrom until their obligations to the bank had been fully satisfied. The Account here, however, contains more than simply the Bank's Collateral. Furthermore, BFG was entitled to withdraw the funds in excess of the Collateral every three months under the terms of the Agreement. It is evident from reviewing the various *amicus* briefs that the Agreement was a standard form used by BFG, and the withdrawal limitation on the Account was a provision it elected to include. It apparently was not a limitation instituted by the various banks. As such, the Court concludes that insofar as the balance in the Account over and above the Collateral is concerned, mutuality of debt did exist between BFG and the Bank as of the Petition Date, and the right of setoff existed at that time as to that portion of the Account comprising the monies in excess of the Collateral.

Trustee makes the argument that even if the Court determines that the Bank had a right of setoff as of the Petition Date, Code §553(a)(3) precludes the Bank from effecting such a setoff to the extent that the Bank's debt to BFG (a) was incurred in the 90 days prior to the Petition Date, (b) while BFG was insolvent[7] and (c) for the purpose of obtaining a right of setoff against BFG.

It is the Trustee's burden to establish that **all** three elements of Code §553(a)(3) are present. *See generally In re Energy Co-op, Inc.*, 100 B.R. 992, 995 (N.D.Ill. 1989). For purposes of this particular discussion, it appears that the important consideration is whether or not the Bank's debt to BFG was incurred for the purpose of obtaining a right of setoff against BFG. In this regard, the courts have been wary of what they perceived as a deliberate manipulation of the

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[7]Code §553(c) states that a debtor is presumed to have been insolvent during the 90 days prior to the filing of the bankruptcy petition.

amounts deposited by either the debtor or the creditor. *See In re Bohlen Enterprises, Ltd.,* 78 B.R. 556, 561 (Bankr. N.D.Iowa 1987), *aff'd*, 91 B.R. 486 (N.D. Iowa 1987), *rev'd on other grounds,* 859 F.2d 561 (8th Cir. 1988); *In re Allbrand Appliance & Television Co.*, 16 B.R. 10, 14 (Bankr. S.D.N.Y. 1980). Deposits made in the ordinary course of business generally are not deemed to have been made for the sole purpose of obtaining a right to setoff. *Bohlen Enterprises*, 78 B.R. at 560 (indicating that a bank cannot offset a debtor's deposit unless deposits were accepted in good faith in the ordinary course of business); *In re Automatic Voting Mach. Corp*., 26 B.R. 970, 973 (Bankr. W.D.N.Y. 1983). In particular, the courts have examined whether either the debtor or creditor have built up the amount on deposit, thereby increasing the debt owed to the debtor in order to later be able to offset the debt owed by the debtor in a corresponding amount should the need arise. *Bohlen Enterprises*, 78 B.R. at 560.

Trustee contends that since BFG allegedly was involved in a "Ponzi" scheme, none of the transactions between BFG and the Bank should be considered to have been in the "ordinary course of business." The cases cited by the Trustee in support of this argument involved alleged preferential transfers which the Trustee sought to avoid pursuant to Code §547. *See Bozek v. Danning (In re Bullion Reserve of North America*), 836 F.2d 1214, 1219 (9th Cir.), *cert. denied*, 486 U.S. 1056, 108 S.Ct. 2824, 100 L.Ed.2d 925 (1988); *Graulty v. Brooks (In re Bishop, Baldwin, Rewald, Dillingham & Wong, Inc.)*, 819 F.2d 214, 216 (9th Cir. 1987); *In re Montgomery*, 123 B.R. 801, 814-15 (Bankr. M.D.Tenn. 1991). Code §547(c)(2)(B) provides an exception to a trustee's avoidance powers to the extent that a transfer sought to be avoided as a preference was "made in the ordinary course of business or financial affairs of the debtor and the transferee." Code §553 contains no such language. The fact that a debtor's business operations

may have been conducted as part of a Ponzi scheme and may be deemed not to have been in the "ordinary course of business" simply eliminates an exception that would have otherwise prevented a trustee from exercising its avoidance powers. However, in this case there has been no suggestion that the Bank's business dealings with BFG were in any way fraudulent or conducted with knowledge of the "Ponzi scheme". Indeed, the Bank is but one of the thousands of victims of the alleged scheme in this case and should not be precluded from exercising its right to setoff simply on mere allegations that BFG was involved in a Ponzi scheme.

According to Chambers' Affidavit, the balance in the Account on a monthly basis for the year prior to the Petition Date ranged from a low of $40,328.03 in August 1995 to a high of $53,691.75 in March 1996, with an average balance of $50,539.14 over the twelve month period. The Trustee has not provided the Court with any evidence of manipulative actions on the part of either the Bank or BFG or any unusual build-up in the Account to establish that the debt owed BFG by the Bank was incurred for the purpose of obtaining a right of setoff against BFG. Accordingly, the Court finds that the Bank is not precluded from exercising its right of setoff based on Code §553(a)(3)(C). It is also unnecessary for the Court to address the other two grounds set forth in Code §553(a)(3) as the statute requires that **all** three be proven if the exception is to apply.

Having concluded that the exception to setoff found in Code §553(a)(3) is not applicable to the matter herein, the Court must still make a determination whether to permit the Bank to exercise its right of setoff. This is a matter of the Court's discretion. *Bohack Corp. v. Borden, Inc.*, 599 F.2d 1160, 1168 (2d Cir. 1979); *Sentinel Products*, 192 B.R. at 45 (citations omitted). This requires that the Court "'scrutinize the right of setoff in light of the Bankruptcy Code's goals

and objectives.'" *Ionosphere Clubs*, 164 B.R. at 841, quoting *Illinois v. Lakeside Community Hosp. Inc., (In re Lakeside Community Hosp., Inc.)*, 151 B.R. 887, 890 (N.D.Ill. 1993). While these goals include equitable treatment of all creditors, the Second Circuit Court of Appeals has indicated that '[t]he doctrine of setoff has long occupied a favored position in our history of jurisprudence" despite the fact that setoff "has the effect of paying one creditor more than another." *Bohack Corp.*, 599 F.2d at 1164, 1165. The right of setoff is to be enforced unless there are "compelling circumstances" to the contrary. *Id.* at 1165. For instance, in *In re Utica Floor Maintenance, Inc.*, 41 B.R. 941 (N.D.N.Y. 1984), the district court acknowledged that the bankruptcy court had appropriately deferred setoff which would have otherwise posed "an immediate and serious threat to the reorganization of the debtor." *Id.* at 945; *see also Bohack Corp.* 599 F.2d at 1167 (stating that "[w]here the immediate setoff would seriously threaten the continued vitality of the debtor, the setoff should be deferred."). Trustee has not suggested that allowing the Bank to exercise its right to setoff would in any way pose a threat to the BFG's reorganization. Indeed, throughout the proceedings of this case there have been numerous suggestions, which have not been disputed by Trustee, that BFG has no intention of or ability to reorganize. Nor has he asserted that granting the relief will in any way interfere with the orderly administration of the case. What the Trustee does contend is that permitting the Bank to effect a set-off would "lead to the inequitable result of allowing banks to obtain money stolen from the pockets of individual investors -- many of whom are literally losing their houses -- pursuant to a Ponzi scheme." See pg. 15 of Trustee's Reply Memorandum of Law.

The Court certainly is not blind to the havoc caused as a result of the prepetition activities of the debtor. Trustee asks the Court to consider the equities of the case from the perspective of

the thousands of individual investors who have been personally affected. Apparently, as a financial institution the Bank is somehow deemed to be in a better position to "weather the storm" than the individual investors. The fact that the Bank may have somewhat larger pockets than the individuals investors does not make the "theft" any less unconscionable. The Court has been presented with no compelling circumstances to either deny or defer the relief the Bank seeks. Given the position taken by the Second Circuit that the right of setoff is to be enforced in the absence of compelling circumstances to the contrary, it is the holding of this Court that the stay imposed pursuant to Code §362(a) be modified and that the Bank be permitted to exercise its right of setoff to the extent of the monies in excess of the Collateral on deposit in the Account and that the balance of any monies in the account be turned over to the Trustee.[8]

IT IS SO ORDERED.

Dated at Utica, New York

this day of November 1996

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[8]According to the Court's calculations, the Collateral amounts to $2,719.38, the total of one month's payments on the two lease portfolios, as of the petition date. There was, according to the Bank, $54,691.75 on deposit in the Account as of the Petition Date. The Bank claims it is owed $23,909.56. Allowing it to setoff said amount, the Trustee is entitled to recover $29,782.19, plus any interest that has accrued on the Account since the Petition Date.

STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge