UNPUBLISHED OPINION

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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

In re PARK MEADOWS INVESTMENT CO., aka PARK MEADOWS DEVELOPMENT CO., a Utah Partnership, Debtor.	Bankruptcy Case No. 86C-01060 (Chapter 7)
In re PLUTARCH COMPANY, a Utah Corporation, Debtor.	Bankruptcy Case No. 86C-01885 (Chapter 7)
F. WAYNE ELGGREN, Trustee, Plaintiff, vs. ENOCH SMITH SONS COMPANY, Defendant.	Adversary Proceeding No. 89PC-0510 MEMORANDUM OPINION AND ORDER

The matter presently before the court is a motion filed by the defendant, Enoch Smith Sons Company ("defendant"), for partial summary judgment of the above-captioned adversary proceeding. A hearing was held on May 22, 1990. Carolyn Montgomery appeared on behalf of the trustee, F. Wayne Elggren ("trustee"). Hardin A. Whitney appeared on behalf of the defendant. Counsel presented argument after which the court took the matter under advisement. The court has carefully considered and reviewed the arguments of counsel and memoranda submitted by the parties and has made an independent review of the pertinent authorities. Now being fully advised, the court renders the following decision.

On March 14, 1986, an involuntary petition for relief under Chapter 11 of the Bankruptcy Code was filed against Park Meadows Investment Company ("Park Meadows"). Subsequently the case was converted to a case under Chapter 7 and the trustee was appointed. On July 17, 1989, the trustee filed the instant adversary proceeding against the defendant alleging that certain transfers that Park Meadows had made during the pre-petition year are avoidable as preferential transfers under 11 U.S.C. § 547(b)[1] and are recoverable by him from the defendants under § 550(a).

It is undisputed that Park Meadows was a partnership that was formed to develop a resort in Park City, Utah. The partnership consisted of Enoch Smith, Vic

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[1]Unless stated otherwise, all future references to statutory sections are to Title 11 of the United States Code.

Ayers, and Dick Smith. Enoch and Dick Smith also controlled the defendant corporation and Plutarch Company, a Utah corporation ("Plutarch").[2]

Park Meadows, the defendant, and Plutarch transacted business with each other and, therefore, the entities were debtors and creditors of each other. Relevant to this proceeding are the following debts: (1) Park Meadows was indebted to the defendant in the amount of approximately $1,028,835.00 for construction work that the defendant had done for it and loans which the defendant had made to it; (2) Plutarch was indebted to Park Meadows in the amount of approximately $581,165.00 for loans and property transfers that Park Meadows had made to it; and (3) the defendant was indebted to Plutarch in the amount of approximately $527,920.00 for loans and property transfers that Plutarch had made to it.

On March 31, 1985, within one year of the filing of the bankruptcy petition, a series of bookkeeping entries were made on the financial records of Park Meadows, Plutarch, and the defendant. The entries can be summarized as follows: (1) Park Meadows reduced Plutarch's debt to it by $527,882.00; (2) Plutarch reduced the defendant's debt to it by $527,882.00; and (3) the defendant reduced Park Meadows' debt to it by $527,882.00.

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[2]Plutarch filed a petition for relief under Chapter 11 of the Bankruptcy Code on May 2, 1986. On August 5, 1986, this court entered an order approving a joint application for joint administration and procedural consolidation of the Park Meadows and Plutarch estates. Like the Park Meadows case, the Plutarch case was subsequently converted to a case under Chapter 7 of the Code.

The trustee maintains that the net result of these bookkeeping entries is a payment by Park Meadows on its debt to the insider-defendant thereby creating a reduction of its assets available for distribution to creditors. According to the trustee, the entries are transfers that are avoidable under § 547(b) because they were made within one year of the filing of the bankruptcy petition, to or for the benefit of the insider-defendant, on account of an antecedent debt that was owed by Park Meadows, and which allowed the defendant to receive more than it would have received if the transfer had not been made and if it had received payment of the debt under provisions of the Bankruptcy Code. In the present motion, the defendant argues that the bookkeeping entries cannot be classified as "transfers" for purposes of avoidability under § 547(b). In particular, the defendant maintains that the journal entries constitute a timely "triangular" setoff under § 553.

For purposes of avoidance under § 547(b), there must be a "transfer of an interest of the debtor in property .... " "Transfer" is broadly defined in § 101(50) as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption." As originally drafted by the House, the Code was to have included setoff in the definition of transfer. H.R. 8200, 95th Cong., 1st Sess. 321 (1977), *reprinted in* 12 BANKRUPTCY REFORM ACT OF 1978: A LEGISLATIVE HISTORY, Doc. 41 (A. Resnick & E. Wypyski

eds. 1979). However, Congress ultimately adopted the Senate's version of the bill which excluded setoff from the definition of transfer. Thus, since a setoff is not a "transfer," the elements of a preference under § 547(b) cannot be satisfied. *Eckles v. Petco, Inc., Interstate (In re Balducci Oil Co.)*, 33 B.R. 847, 852 (Bankr. D. Colo. 1983); 2 COLLIER ON BANKRUPTCY ¶ 101.50 (15th ed. 1990).

"Setoff is the right that exists between two parties to net their respective debts where each party, as a result of unrelated transactions, owes the other an ascertained amount." *Tradex, Inc. v. United States (In re IML Freight, Inc.)*, 65 B.R. 788, 791 (Bankr. D. Utah 1986). Section 553(a) provides that bankruptcy "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under [Title 11] against a claim of such creditor against the debtor that arose before the commencement of the case .... " In *IML Freight*, 65 B.R. at 793, this court stated that to establish a right to setoff, the creditor must prove:[3]

> (1) a debt owed by the creditor to the debtor which arose prior to the commencement of the bankruptcy case; (2) a claim of the creditor against the debtor which arose prior to the commencement of the bankruptcy case; and (3) the debt and the claim must be mutual obligations.

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[3]The trustee has not asserted that the claims of the defendant are disallowed, and all of the transactions took place well before 90 days prior to the filing of the petition against Park Meadows. Accordingly, the limitations of 11 U.S.C. § 553(a) and (b) do not apply to the extent that the defendant can prove that it has a valid right to setoff.

The court went on to state that:

> The critical determination ... is whether or not the parties' debts are 'mutual.' The term 'mutual debt' is not defined in the Bankruptcy Code, but has been interpreted by courts to require that the debts be in the same right and between the same parties, standing in the same capacity. *See* [4] COLLIER ON BANKRUPTCY, ... ¶ 553.04[2], at 533-18 [(15 ed. 1986)]; [3] REMINGTON ON BANKRUPTCY, ... § 1445, at 399 [(J. Henderson rev. 1957)]. The basic test of mutuality is not similarity of obligation but whether or not something is owed by each side. 4 COLLIER ON BANKRUPTCY ¶ 68.04[2], at 862-63 (14th ed. 1978). The creditor's debt must be owed to the estate of the debtor and the estate's debt must be owed to the creditor. *See id.* at 868. There is no requirement that the debt and the claim arise from the same transaction. *See Inter-State National Bank of Kansas City v. Luther*, 221 F.2d 382 (10th Cir. 1955); *In re Midwest Service and Supply Co., Inc.*, 44 B.R. 262, 265-66 (D. Utah 1983); *Matter of Romano*, 52 B.R. 586, 589 (Bkrtcy. M.D. Fla. 1985). In fact, the mutual debt and the claim contemplated by Section 553(a) 'are generally those arising from *different* transactions.' 4 COLLIER ON BANKRUPTCY[, *supra*] ¶ 553.03, at 553-12.

Id. (emphasis in the original); *see also In re Davidovich*, No. 89-1035, slip op. at 8 (10th Cir. May 2, 1990) (1990 WESTLAW 55570) (discussing elements of setoff). Accordingly, the right to setoff applies only to those situations in which the debtor and the creditor owe a debt to one another. *See Cohen v. Savings Bldg. & Loan Co. (In re Bevill, Bresler & Shulman Asset Management Corp.)*, 896 F.2d 54, 57 (3rd Cir. 1990); *Lomia v. United States (In re Art Metal U.S.A., Inc.)*, 109 B.R. 74, 78 (Bankr. D.N.J. 1989). The mutuality requirement is strictly construed. *Art Metal*, 109 B.R. at 78;

Balducci Oil, 33 B.R. at 851; *Virginia Block Co. v. Bushong (In re Virginia Block Co.)*, 16 B.R. 560, 562 (Bankr. W.D. Va. 1981). Furthermore, the right to "setoff does not arise automatically merely because the creditor and the debtor have mutual debts, but only occurs where there has been a deliberate overt action showing that the creditor has exercised its right of setoff." 4 COLLIER ON BANKRUPTCY, ¶ 553.02, at 553-11 (15th ed. 1990) (citing *Baker v. Nat'l Bank*, 511 F.2d 1016, 1019 (6th Cir. 1975); *Clarkson Co. v. Shaheen*, 533 F. Supp. 905, 925 (S.D.N.Y. 1982); *In re Mealey*, 16 B.R. 800 (Bankr. E.D. Pa. 1982)). Finally, "the right to setoff under section 553 is neither automatic nor self-executing, nor is setoff mandatory. Its application, when properly invoked, rests in the discretion of the Court." *IML Freight*, 65 B.R. at 792. If properly invoked, however, there is a general presumption in favor of setoff. *Id.* This presumption is especially strong in Chapter 7 cases because the setoff will not interfere with the debtor's rehabilitation. *Id.* (quoting H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 183-84 (1977)).

As a general rule, "triangular" setoffs are prohibited because mutuality cannot be created by aggregating the debts and claims of different entities. *Depositors Trust Co. v. Frati Enter., Inc.*, 590 F.2d 377, 379 (1st Cir. 1979); *Baruch Invest. Co. v. Danning (In re Vehm Eng'g Corp.)*, 521 F.2d 186, 190-91 (9th Cir. 1975); *Inland Steel Co. v. Berger Steel Co. (In re Berger Steel Co.)*, 327 F.2d 401, 403-04 (7th Cir. 1964); *Jones v. United States (In re Jones)*, 107 B.R. 888, 897 (Bankr. N.D. Miss. 1989); *In re*

Ingersoll, 90 B.R. 168, 171 (Bankr. W.D.N.C. 1987); 4 COLLIER, *supra* ¶ 553.04[2], at 553-20. One type of factual situation that gives rise to a "triangular" setoff analysis is when one entity ("first entity") is in debt to the debtor, and the debtor is in debt to a second, related, but separate, entity ("second entity"). Upon demand for payment by the debtor of the first entity, that entity asks that the debtor setoff its debt against the debtor's debt to the second entity. *See, e.g., Depositors Trust Co.*, 590 F.2d at 377; *Vehm Eng'g Corp.*, 521 F.2d at 186; *In re Jones*, 107 B.R. at 897; *In re Ingersoll*, 90 B.R. at 171. This factual situation is similar to the facts alleged in the instant case. Park Meadows, Plutarch, and the defendant were related companies. The defendant owed money to Park Meadows, and Park Meadows owed money to Plutarch. The defendant is claiming that the journal entries in question were such that its debts to Park Meadows were setoff against Park Meadows' debts to Plutarch.

Although mutuality does not appear to exist in this proceeding, there is a narrow exception to the general rule against three-party, "triangular" setoffs. In particular, mutuality will be found if "as a matter of contract law, a court finds that the debtor has formally agreed that two entities may aggregate debts owed to and from the debtor for setoff purposes .... " 4 COLLIER, *supra* ¶ 553.04[2], at 553-21 (citing *Berger Steel Co.*, 327 F.2d at 401; *Bloor v. Shapiro*, 32 B.R. 993, 1001-1002 (S.D.N.Y. 1983); *In re Fasano/Harriss Pie Co.*, 43 B.R. 864 (Bankr. W.D. Mich), *aff'd sub nom.*, 70 B.R. 285 (W.D. Mich.), *aff'd*, 848 F.2d 190 (6th Cir. 1988); *Balducci Oil*, 33 B.R. at 847; *Virginia*

Block Co., 16 B.R. at 560); *see also Depositors Trust Co.*, 590 F.2d at 379; *Vehm Eng'g Corp.*, 521 F.2d at 190-91; *In re Ingersoll*, 90 B.R. at 171. Courts will also allow a "triangular" setoff if the related entities are *alter egos* of one another. *See Vehm Eng'g Corp.*, 521 F.2d at 190-91; *In re Jones*, 107 B.R. at 898; *In re Ingersoll*, 90 B.R. at 172. Issues regarding *alter ego* and the existence of an agreement are questions of fact and, therefore, summary judgment is not appropriate at this time.

Accordingly, it is HEREBY ORDERED that the defendant's motion for summary judgment be DENIED.

DATED this 29 day of June, 1990.

BY THE COURT:

Glen E. Clark

GLEN E. CLARK, CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT