UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

IN re AAPEX SYSTEMS, INC.,

Debtor.

LUCIEN MORIN, II, Trustee,

Plaintiff, Appellee,

v.

SOUTH WILLIAMSPORT SABRECOM, INC.,

Defendant, Appellant,

LUCIEN MORIN, II, Trustee,

Plaintiff, Appellee

v.

CANTON SABRECOM, INC.,

Defendant, Appellant.

DECISION AND ORDER

00-CV-6137L

On December 30, 1999, Bankruptcy Judge John C. Ninfo, II issued a Decision and Order in this Chapter 7 adversary proceeding, denying motions for summary judgment filed by the three defendants. Two of those defendants, Canton Sabrecom, Inc. and South Williamsport Sabrecom, Inc. ("appellants")[1], have appealed from that Decision and Order. For the following reasons, the bankruptcy court's Decision and Order is affirmed.

BACKGROUND

This appeal requires the Court to consider and balance two, sometimes competing, legal policies: the first favors the equality of distribution of assets among creditors of a bankrupt's estate; the second favors the collection of taxes for the benefit of the Internal Revenue Service ("IRS"). On the facts presented here, the conflict is more imagined than real. To adopt appellants' position would seriously affect the important policy of equality of distribution of assets and provide no appreciable benefit to the IRS in its efforts to collect taxes.

The facts giving rise to this appeal are largely, if not entirely, undisputed. Aapex Systems, Inc. ("Aapex"), the debtor in this action, was engaged in the business of providing payroll services to employers. In December 1995, Aapex contracted with appellants to provide such services to them, including services relating to payroll taxes. The arrangement was that each pay period, appellants would inform Aapex of certain payroll information, and Aapex would determine how much payroll tax should be withheld for each employee. Appellants would then transfer funds to

[1]Both appellants are subsidiaries of Sabre Communications, Inc.

Aapex in the amount of their employees' gross pay (including payroll tax amounts), and Aapex was to remit those funds to the Internal Revenue Service ("IRS") and other government agencies in satisfaction of appellants' payroll tax liabilities.

In late 1997, the IRS sent appellants deficiency notices informing them that they owed back payroll taxes. Appellants contacted Aapex about this deficiency, and Aapex provided appellants with a certified check for approximately $138,000, which appellants remitted to the IRS to cover the unpaid taxes.

In February 1998, an involuntary Chapter 7 petition was filed against Aapex. The Chapter 7 Trustee wrote to appellants and demanded the return of the $138,000, claiming it was an avoidable preferential transfer under 11 U.S.C. § 547(b). He also demanded the return of roughly $30,000 that allegedly had been paid by Aapex directly to the IRS on appellants' behalf.

Appellants refused to return the funds, contending that the monies paid to the IRS had been held "in trust" for the United States and, therefore, were not property of the debtor, Aapex. The Trustee then commenced this action, seeking an order declaring the transfers avoidable, and directing appellants to turn over the amount of the transfers.

Appellants filed motions to dismiss, which Bankruptcy Judge Ninfo treated as motions for summary judgment. He denied the motions, stating that he could not determine at this stage whether the transferred funds were trust funds, although he added that the evidence presented up to that point did not indicate that they were trust funds. This appeal followed.

DISCUSSION

I. Standard of Review

Bankruptcy Rule 8013 states that "[o]n an appeal the district court . . . may affirm, modify, or reverse a bankruptcy court's judgment, order, or decree or remand with instructions for further proceedings. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the bankruptcy court to judge the credibility of the witness." In reviewing a decision of the bankruptcy court, this court "'must accept the bankruptcy court's findings of fact unless [they are] clearly erroneous,' and will reverse the Bankruptcy Court 'only if [it is] left with the definite and firm conviction that a mistake has been committed.'" *In re Schubert*, 143 B.R. 337, 341 (S.D.N.Y. 1992) (citing *In re Mansville Forest Prods. Corp.*, 896 F.2d 1384, 1388 (2d Cir. 1990). Conclusions of law are reviewed *de novo*. *In re Mansville*, 896 F.2d at 1388 (citing *Brunner v. New York State Higher Educ. Services, Corp.*, 831 F.2d 395, 396 (2d Cir. 1987).

In the case at bar, the facts do not appear to be in dispute. The only issue presented here is a legal one–whether the transferred funds were trust funds held for the United States, or simply funds of Aapex, the debtor. I therefore review the bankruptcy court's decision *de novo*.

II. Whether the Transferred Funds Were Trust Funds

Any analysis of the issues presented on appeal here requires consideration of several pertinent statutes. The first, 11 U.S.C. § 547(b), provides in part:

> (b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property–

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made–
(A) on or within 90 days before the date of the filing of the petition ... .

Also relevant is 11 U.S. § 550, which provides in part:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from–
(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
(2) any immediate or mediate transferee of such initial transferee.

Finally, 26 U.S.C. § 7501(a) provides:

General rule.–Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States. The amount of such fund shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose.

Appellants take the position that the transfers here were not avoidable because they were not transfers of an interest of the *debtor*. Appellants contend that those monies had been held in trust for the United States under § 7501(a), and hence were monies that in fact belonged to the United States.

In support of that assertion, appellants rely on the Supreme Court's decision in *Begier v. I.R.S.*, 496 U.S. 53 (1990). In *Begier*, the debtor had been ordered by the IRS to deposit its payroll taxes into a separate bank account after the debtor fell behind in its payments. The debtor did so, but did not deposit sufficient funds to cover the amount of taxes owed. The debtor was able to

remain current on its tax payments, however, by paying them partly from the separate account and partly from its general operating funds. After bankruptcy proceedings were initiated, the trustee commenced an adversary proceeding against the IRS to recover the amounts paid by the debtor to the IRS for ninety days prior to the bankruptcy filing. The bankruptcy and district courts held that the amounts paid out of the separate account were held in trust and were not avoidable, but that the amounts paid out of the debtor's general operating funds were property of the debtor, and could be avoided. On appeal, the Third Circuit held that *all* prepetition payments were trust funds, and not avoidable, regardless of the source.

The Supreme Court affirmed. Stating that "[e]quality of distribution among creditors is a central policy of the Bankruptcy Code," *id.* at 58, the Court said that the debtor had created a trust automatically every time it paid its employees. The Court also said that § 7501 creates a trust in an abstract amount, not tied to any particular assets, so that common-law tracing rules cannot really be used to trace specific funds. A debtor's voluntary payment of its trust-fund tax obligation, the Court stated, establishes the required nexus between the amount held in trust and the funds paid to the IRS. *Id.* at 66-67.

In *Hamilton Taft & Co. v. S & S Credit Co.* ("*Taft*"), 53 F.3d 285 (9th Cir.), *vacated on other grounds, appeal dismissed*, 68 F.3d 337 (9th Cir. 1995),[2] however, the Ninth Circuit declined to extend *Begier* to a factual situation similar to that presented in the case at bar. In *Hamilton Taft*, the debtor also was engaged in the business of performing payroll services, including tax payments. Except for two clients who had specifically contracted for segregated treatment of their funds, the

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[2]The decision was vacated when the case settled.

funds that the debtor received from the defendant and other employers were commingled and used by the debtor for its own purposes until the taxes became due. Just before the filing of an involuntary bankruptcy petition against the debtor, the defendant employer was notified by the IRS that it was going to be audited. The defendant therefore asked the debtor for proof that its payroll taxes were up to date. In fact they were not, but to conceal that from the defendant, the debtor immediately issued checks to the IRS for over $7.5 million, and sent proof of payment to the defendant. As a result, when the bankruptcy petition was filed, the defendant owed only $159,000 in unpaid taxes, whereas the debtor's other clients owed millions of dollars. The trustee then filed an action against the defendant employer to recover the $7.5 million that the debtor had paid to the IRS on behalf of the defendant.

The bankruptcy court dismissed the complaint on the ground that the taxes were property of the estate, and the district court affirmed. The Ninth Circuit reversed, however, stating that although it was "clear that the funds [defendant] withheld from its employees were impressed in a statutory trust when *collected*," *id.* at 288, the defendant's transfer of the trust-fund taxes to the debtor, without any prior arrangement that they were to be segregated and held in trust, meant that the debtor did not hold the funds in trust for the United States. Because the debtor had commingled and used the funds for its own benefit, the court reasoned, the funds were property of the debtor.

The court also determined that the holding of *Begier* was not directly applicable because *Hamilton Taft* was not a case involving a debtor paying its *own* tax obligation, but rather a debtor paying the obligation of a third party pursuant to a contract, a fact that the court described as "of paramount importance." *Id.* at 289. Unlike *Begier*, the court added, this case did not implicate the

ability of the IRS to collect taxes, since the debtor's clients remained liable to the IRS and could presumably pay the taxes that they owed. Since the policy favoring collection of taxes was thus not involved, the court stated that it would not extend *Begier* in such a way as to undermine the policy in favor of equality of distribution among creditors. *Id.* at 290.

After reviewing the record and relevant statutes and case authority, I concur with Bankruptcy Judge Ninfo's conclusion that extension of the *Begier* holding to the facts in this case, at this stage of the proceedings at least, is unwarranted. In short, it appears that the funds turned over by appellants to Aapex were not, and not intended to be, trust funds. Rather, upon their receipt by Aapex, those funds became property of Aapex, which had been commingled with other funds from other clients of Aapex and from other sources. Moreover, as in *Hamilton Taft*, this case does not implicate the policy favoring collection of taxes, but should appellants be granted the relief that they seek, it would directly and negatively affect the policy favoring equality of distribution among creditors.

Certainly appellants could have paid their taxes directly to the IRS, or contracted to have their funds held in trust by Aapex. Instead, they chose to pay monies to Aapex, with no such provision or restriction in their contracts, while themselves remaining liable to the IRS. Aapex may have been *contractually* obligated to pay appellants' taxes, but nothing in the Tax Code or the parties' contracts gave rise to a § 7501 trust. The IRS had no direct right of action against Aapex. Once appellants paid funds to Aapex, those funds became property of Aapex, and if Aapex failed to pay appellants' taxes, appellants' liability to the IRS remained unchanged. In that situation, appellants were simply left with a cause of action for breach of contract, like any other client of

Aapex whose taxes went unpaid because of defalcation by Aapex. There is no reason why Aapex's other clients should have to receive a reduced recovery from the estate merely because appellants happened to receive an audit notice from the IRS, and consequently inquired of Aapex about their tax payments, shortly before the bankruptcy proceeding was commenced.

I am also unpersuaded by appellants' contention that they run the risk of incurring double liability in the sense that they paid monies to Aapex, and now may have to pay the IRS directly as well. Appellants have but a single tax obligation to the IRS; nothing that Aapex did or did not do changed that. The fact that appellants may have paid monies to Aapex in the expectation that Aapex would pay their taxes for them did not relieve appellants of their tax obligations. The funds paid to Aapex were paid pursuant to a contract, which contained no provision that the funds were to be held in trust or segregated from other clients' funds. If Aapex breached that contract, then appellants, as creditors, have a remedy in the bankruptcy proceedings against the estate. The fact that they may not recover one hundred percent of the monies that they turned over to Aapex is simply the unfortunate result faced by many creditors in bankruptcy proceedings.

In addition, as in *Hamilton Taft*, the policy in favor of payment of taxes is not implicated here. The duty to the IRS to pay taxes was not owed by Aapex, but by appellants. That duty remains intact, and there is no indication that avoidance of the transfers at issue will have any effect at all on the IRS, since appellants presumably are able to pay the IRS the taxes that they owe. Conversely, were appellants' position to be adopted, the IRS's position would not be jeopardized; the only effect would be on Aapex's other creditors, who would recover less from the estate.

I also note that, had the transfers not occurred by the time the bankruptcy petition was filed, the funds at issue would presumably have been part of the debtor's estate, since they were commingled with Aapex's own funds and the funds of other Aapex clients. As Bankruptcy Judge Ninfo observed, it would have been impossible to separate out any particular funds as trust funds, as opposed to Aapex's own general funds. It appears, therefore, that the transfers made by Aapex were not transfers of trust funds, but of funds in which the debtor had an interest. As such, they would be avoidable pursuant to § 547(b).

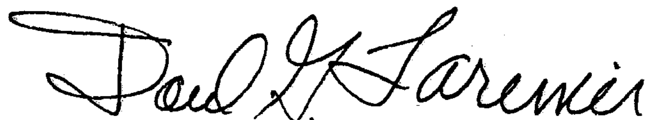
Although Bankruptcy Judge Ninfo stopped short of determining as a matter of law that the funds at issue are not trust funds, based on the record before me it is difficult to see how they could be. The parties have not indicated that any material facts are in dispute, and presumably both sides made their best evidentiary showing on this issue in their presentations to the bankruptcy court. In fact, since the only real issue before the court is one of law, it would not necessarily have been an abuse of discretion for the bankruptcy court *sua sponte* to have entered judgment on this issue in favor of the non-moving party, the Trustee, a practice that is clearly permitted under established case law. *See, e.g., Coach Leatherware Co. v. AnnTaylor, Inc.*, 933 F.2d 162, 167 (2d Cir. 1991) ("Though not expressly authorized by Rule 56, this practice has become an accepted method of expediting litigation") (citing *Celotex Corp. v. Catrett*, 477 U.S. 317, 326 (1986)); *see also Community Bank, Nat'l Ass'n v. Lyons (In re Lyons)*, 177 B.R. 767, 771 (Bankr. N.D.N.Y. 1994) (granting summary judgment *sua sponte* for nonmoving party in bankruptcy adversary proceeding), *aff'd*, 177 B.R. 172 (N.D.N.Y. 1995). However, since the Second Circuit has cautioned courts that they should rarely do so without giving the moving party prior notice and an opportunity to respond,

see Bridgeway Corp. v. Citibank, 201 F.3d 134, 139 (2d Cir. 2000), and since the only issue actually before this court is whether to affirm or reverse Bankruptcy Judge Ninfo's Decision and Order, I decline to direct the bankruptcy court to enter judgment on this issue in the Trustee's favor, but instead simply remand for further proceedings consistent with this Decision and Order.

CONCLUSION

The Decision and Order of the bankruptcy court entered on December 30, 1999, is hereby affirmed.

IT IS SO ORDERED.



DAVID G. LARIMER
CHIEF JUDGE
UNITED STATES DISTRICT COURT

Dated: Rochester, New York
November 21, 2000.

ATTEST: A TRUE COPY
U.S. DISTRICT COURT, WDNY
RODNEY C. EARLY, CLERK

By
Deputy Clerk

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