

**UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK**

In Re:

Interco Systems, Inc.,

BK. NO. 93-20144

Debtor.

C. Bruce Lawrence, Trustee,

Plaintiff,

A.P. NO. 95-2048

vs.

**Seatt Corporation, f/k/a Maple Chase
Company,**

DECISION & ORDER

Defendant.

BACKGROUND

On January 26, 1993, three "Supplier" creditors of the debtor, Interco Systems, Inc. ("Interco"), filed an involuntary Chapter 7 petition alleging that Interco was not paying its debts as they became due. Interco interposed an answer, claiming that the indebtedness alleged by each of the petitioning creditors was in dispute, and requested that the petition be dismissed. At a pretrial conference on March 16, 1993, Interco indicated that it wished to remain in the Bankruptcy Court and attempt to reorganize under Chapter 11. Because Section 706(a) gives a Chapter 7 debtor acting in good faith the absolute right to convert to Chapter 11 if the case has not previously been converted, counsel for the petitioning creditors and Interco agreed to discuss Interco's desire to proceed in Chapter 11 as an alternative to conducting a trial of the issues under Section 303(h). To afford the parties time for such further discussion, a trial on the involuntary petition was scheduled for April 2, 1993. On April 1, 1993, a stipulation between Interco and the petitioning creditors was filed with the Court. The stipulation agreed that Interco would go forward with a voluntary Chapter 11 case. After some procedural matters were corrected, the case went forward in Chapter 11 with January 26, 1993 deemed to be the order for relief date.

On June 14, 1993, the Creditors Committee formed in the Chapter 11 case filed a motion pursuant to Section 1112(b) which requested that the Interco case be converted to a Chapter 7 case, or, in the alternative, that a trustee be appointed pursuant to Section 1104(a) (the "Conversion Motion"). Full day evidentiary hearings were held on June 18, 21, 23, 28 and July 9, 1993, and oral argument by counsel was presented on July 14, 1993, at which time the Court reserved on the Conversion Motion.

By a written decision issued on July 19, 1993 the Court determined that the Interco Chapter 11 case should be converted to a Chapter 7 case for cause, and thereafter on July 21, 1993 the designation of the Office of the United States Trustee appointing C. Bruce Lawrence as Trustee (the "Trustee") was filed with the Court.

Interco's business can best be described as a buying group (the "Interco Buying Group"). In the late 1970's and throughout the 1980's, it organized "Subscribers," generally small to medium wholesale or retail distributors of electrical and plumbing supplies located all across the country, and placed orders on their behalf with "Suppliers," manufacturers or national wholesalers of plumbing and electrical supplies. Because Interco made such large purchases with the Suppliers, it was able to negotiate volume sales discounts ("VSD's") with the Suppliers, between 1% and 13% of purchases, which were then split between the Subscribers and Interco. Interco was also providing Suppliers with greater market penetration, since they might not otherwise obtain orders from many of the Interco Subscribers, which further justified the payment of VSD's. Although during this period, in many if not most cases, orders were actually placed directly by Subscribers with the Suppliers and the goods shipped directly to the Subscribers, nevertheless, Interco was paid for the goods by the Subscribers and it was Interco that was billed by and paid the Suppliers. As a result, during the 1980's when there were very few, if any, defaults in payment by Subscribers, Interco was able to generate substantial profits from its share of VSD's, sign-up fees paid by new Subscribers and

the significant "float" on monies received by Interco from the Subscribers before the Suppliers' invoices were due. In its best year, 1989, Interco handled purchases of in excess of \$264,000,000, generating income before taxes of in excess of \$2.9 million. After 1989, the recession hit, building was down nationwide, the volume of purchases decreased, and Subscribers began defaulting on their payments to Interco. However, Interco was still legally obligated to pay the Suppliers for the goods, it was not earning as much on the float, and it failed to react quickly to the change in the business environment and reduce its expenses. As a result, before taxes, Interco lost in excess of \$2,000,000 in 1990 and \$3,000,000 in 1991.

In 1992 Interco began trying to negotiate contracts with Suppliers which would provide that although the Suppliers would now bill and receive payment directly from the Subscribers, they would still pay the VSD's to Interco, which Interco would continue to divide between it and the Subscribers. Under these contracts (the "Direct Payment Contracts") Interco would not have any credit risk in connection with purchases, but it would also no longer be supplying credit support to the Suppliers, an element of value which at least some of the Suppliers had relied heavily upon. Some of the Suppliers entered into these Direct Payment Contracts. Other Suppliers terminated their relationships with Interco, but in some cases continued to deal directly with former or existing Interco Subscribers.

In January, 1995 the Trustee commenced in excess of 350 separate adversary proceedings to recover alleged avoidable preferences, post-petition transfers and fraudulent conveyances. Among these adversary proceedings was this Adversary Proceeding against Seatt Corporation ("Seatt") where the Trustee included in his Complaint a cause of action to recover, as an avoidable preference, a payment in the amount of \$2,915.47 made by Interco to Seatt on December 17, 1992, a date which was within ninety days of the filing of the involuntary petition against Interco.

The facts are not in dispute that:

- (1) Seatt was a former Supplier to the Interco Buying Group.
- (2) Seatt was unwilling to enter into a Direct Payment Contract and terminated its relationship with Interco and the Interco Buying Group in August, 1992.
- (3) On or about August 31, 1993, Seatt filed a Proof of Claim in the Interco Chapter 11 case for in excess of \$233,000, the amount Seatt claimed was owed to it by Interco on unpaid invoices for goods sold prior to August, 1992 when Seatt terminated its relationship with the Interco Buying Group.
- (4) After Seatt terminated its relationship with the Interco Buying Group in August, 1992, it continued to sell goods directly to some of the former Subscribers of the Interco Buying Group.
- (5) After Seatt terminated its relationship with the Interco Buying Group in August, 1992, any sales it made to former Subscribers of the Interco Buying Group were based on orders placed directly by the Subscriber which were then shipped and invoiced directly to the Subscriber to be paid for directly by the Subscriber to Seatt.
- (6) One of the former Subscribers of Interco which Seatt sold goods to after August, 1992 was Circle Electric Company ("Circle Electric").
- (7) Circle Electric mistakenly paid Interco \$2,915.47, the amount due on three invoices rendered to Circle Electric by Seatt for goods sold.
- (8) Rather than returning the check of Circle Electric or endorsing it and forwarding it to Seatt, Interco deposited the Circle Electric check into one of its general accounts.
- (9) Thereafter, by its check dated December 17, 1992, Interco forwarded the amount which it mistakenly had received from Circle Electric to Seatt.

On October 18, 1995, the Trustee filed a Motion for Partial Summary Judgment (the "Summary Judgment Motion"). In the Summary Judgment Motion, the Trustee contended that: (1) all of the elements existed which were required by Section 547(b) for a determination that the payment made by Interco to Seatt was avoidable as a preferential transfer; (2) the element required by Section 547(b)(1), that the transfer be to or for the benefit of a creditor, was satisfied in that Seatt was a creditor of the Debtor because at the time of the payment it had a restitution claim against Interco for the return of the erroneous payment made to Interco by Circle Electric; and (3) the element required by Section 547(b), that the transfer be a transfer of an interest of the debtor in property, was satisfied in that once Interco deposited the Circle Electric check into its general

account and commingled it with other property of the Debtor, those funds became property of the Debtor's estate which was then diminished by the payment to Seatt.

On October 26, 1995, Seatt filed a Cross-Motion for Summary Judgment (the "Cross-Motion"). In its Cross-Motion Seatt contended that: (1) the payment by Interco to Seatt in December, 1992 was not a transfer of an interest of the Debtor in property because Interco had received and held the mistaken payment from Circle Electric as a constructive trustee under New York law and general principles of equity; (2) there was no depletion of the Debtor's estate at the time of the payment from Interco to Seatt because Interco held only bare legal title to the funds mistakenly paid by Circle Electric to Interco which never became property of the Debtor's estate; and (3) Interco, the Interco bankruptcy estate and the Interco creditors would be unjustly enriched if the Court failed to impress a constructive trust upon the funds mistakenly paid to Interco and allowed those funds, after properly having been paid over to Seatt, to be recovered as an avoidable preferential transfer.

DISCUSSION

In a Memorandum of Law, Seatt cited to the Court *In re Koreag, Controle et Revision S.A.*, 961 F.2d 341 (2d Cir. 1992), *appeal on other grounds after remand*, 1992 WL 200748 (S.D.N.Y. July 31, 1992), *cert. denied*, 113 S.Ct. 188 (1992), and the cases discussed therein for the proposition that although New York law requires the existence of four factors¹ for the Court to exercise its equitable discretion and impose a constructive trust on property, the key factor and the underlying purpose of the constructive trust doctrine is the prevention of unjust enrichment. In *Koreag*, the Court of Appeals for the Second Circuit adopted a liberal and practical application of the

¹ The four factors are: (1) a confidential or fiduciary relationship; (2) a promise, express or implied; (3) a transfer made in reliance on that promise; and (4) unjust enrichment.

constructive trust doctrine stating that "[w]hat is required, generally, is that a party hold property under such circumstances that in equity and good conscience he ought not to retain it." *Id.* at 354 (citations omitted).

In this case, Interco never had more than bare legal title to the funds mistakenly paid to it by Circle Electric. Interco had provided no services in connection with or in any way related to the payment, and at the time of payment Interco had no existing contractual agreement covering the purchase and sale of goods with either Circle Electric, a former Subscriber, or Seatt, a former Supplier. Its former contractual relationships with Circle Electric and Seatt had terminated after each had elected not to enter into Direct Payment Contracts with the Interco Buying Group. The fact that Interco chose to deposit the Circle Electric check in its account, rather than to return it or endorse it and forward it to Seatt, did not result in Interco obtaining more than bare legal title to the funds. The fact that Interco deposited and commingled the funds did not make the funds property of the estate from an equitable perspective, since Interco had performed absolutely no services in connection with the underlying sale of goods transactions and had no contractual relationship with either of the parties to the transactions.

To allow Interco, the Interco bankruptcy estate and the Interco creditors to have an interest in the funds which were mistakenly paid over to Interco where Interco provided absolutely no services and had no relationship to or involvement in the underlying transaction would allow those parties to be unjustly enriched, contrary to equity and good conscience.

This Court is of the opinion that at the time the funds in question were received by Interco from Circle Electric and then correctly paid over by Interco to Seatt, as the party legally and equitably entitled to the funds, they were impressed with a constructive trust in favor of Seatt. As a result, the funds were not property in which the Debtor had an interest within the meaning and intent of Section 547(b) and the Interco estate was not diminished by their payment to Seatt.

