

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

In Re:

R.J. Russell Associates, Inc.,

Debtor(s).

CASE NO. 96-22155

R.J. Russell Associates, Inc.,

Plaintiff(s),

A.P. NO. 96-2220

vs.

**ReMax Realty Group, Inc., Mary Moffett,
Greater Rochester Association of Realtors, Inc.
Canandaigua National Bank & Trust Co.,**

Defendant(s).

DECISION & ORDER

BACKGROUND

On July 26, 1996, R.J. Russell Associates, Inc. (“Russell Associates”) filed a petition initiating a Chapter 11 case. At the time of the filing of its petition, Russell Associates was a New York State licensed real estate broker authorized to conduct a real estate brokerage business in the State of New York. As such, Russell Associates was engaged in providing services in connection with the purchase and sale of real estate, primarily residential real estate, leasing, property management and relocation. Russell Associates was also a member of the Greater Rochester Association of Realtors, Inc. (the “Association”), a not-for-profit corporation composed primarily of: (1) real estate broker members who are licensed to engage in real estate brokerage businesses;

and (2) associate members, consisting of licensed real estate sales persons (“Salespersons”) who are authorized to engage in the negotiation for the sale or rental of real estate and other activities in the State of New York under the supervision of a licensed real estate broker. At the time of the filing of its petition, Russell Associates estimated that it was either the listing or selling broker in sixty or more purchase and sale transactions where a Purchase and Sale Contract for a residential property (a “Purchase and Sale Contract”) had been entered into between a buyer and a seller prior to the date of the filing of the petition but a closing was not scheduled to occur until after the filing of the petition.

Because it appears that during the last twenty years there has not been a bankruptcy filing in the Western District of New York by a licensed real estate broker with a substantial number of pending transactions at the time of filing, brokers, Salespersons, buyers, sellers, their respective attorneys, and other interested parties, including Canandaigua National Bank & Trust Company (“Canandaigua National”), which holds a perfected security interest in all of the assets of Russell Associates, were unsure of all their rights and obligations with respect to any commissions which Russell Associates might receive or be entitled to receive. Funds to pay commissions were being held by various parties from closings which had already taken place, including some prepetition closings, and there was uncertainty as to what was to be done with commissions which would be payable as closings took place post-petition.

In order to obtain a determination from the Court of the respective rights and remedies of those interested parties as soon as possible, on August 1, 1996 Russell Associates commenced an Adversary Proceeding (the “Adversary Proceeding”) against: (1) Canandaigua National; (2) the

Association, as an entity which Russell Associates perceived to have an interest in the resolution of the overall rights and remedies of the various parties, but an entity which was not a party to any of the Purchase and Sale Contracts; (3) ReMax Realty Group, Inc. (“ReMax”), another licensed real estate broker, as a representative of other similarly situated real estate brokers which might be parties to one or more of the Purchase and Sale Contracts as either a listing or selling broker; and (4) Mary Moffett, a licensed real estate Salesperson who had a pre-petition written working agreement with Russell Associates (a “Russell Associates Salesperson”), as a representative Russell Associates Salesperson, who claimed to be entitled to commissions in connection with one or more of the Purchase and Sales Contracts.

The Russell Associates complaint in the Adversary Proceeding alleged that: (1) Russell Associates had filed a Chapter 11 proceeding for the purpose of obtaining Bankruptcy Court supervision of the liquidation of its business and to ensure that all of those having claims against it and its property would be treated fairly, have their claims, interests, and relative priorities thereof determined by a Court according to law and in a fair and equitable manner; (2) Russell Associates had earned as much as \$1,200,000.00 in unpaid commissions, either as a listing or selling broker, in connection with the transactions covered by the Purchase and Sale Contracts; (3) Russell Associates had entered into various agreements (a “Russell Salesperson Agreement”) with Russell Associates Salespersons, who were independent contractors, which provided for them to be paid commissions; (4) to the extent that the Russell Associates Salespersons had been involved in Purchase and Sale Contracts entered into within ninety days before the filing of the petition, those Salespersons might be entitled to an allowed priority claim of up to \$4,000.00, pursuant to Section

507(a)(3)(B), for commissions earned and received by Russell Associates on those Purchase and Sales Contracts; (5) attorneys for the Association, Moffett, other brokers and other Russell Associates Salespersons had suggested to the attorneys for Russell Associates that the Purchase and Sale Contracts were executory contracts within the meaning and intent of Section 365, which Russell Associates disputed; and (6) although no representative buyer was named as a defendant in the Adversary Proceeding, some buyers under Purchase and Sales Contracts had made deposits to be held by Russell Associates as the listing or selling broker, which buyers might be entitled to an allowed priority claim of up to \$1,800.00 for that deposit, pursuant to Section 507(a)(6), but only in the event that the particular Purchase and Sale Contract did not close.

The Complaint in the Adversary Proceeding requested that the Court determine the relative rights, interests and priorities in the commissions earned by and due to Russell Associates.

On August 5, 1996, the Court entered an Order which: (1) reduced the time for the defendants to answer the Complaint in the Adversary Proceeding; and (2) scheduled a pretrial status conference in the Adversary Proceeding for August 19, 1996, which advised the parties that the Court expected them to be prepared to discuss in detail the law which they believed would be applicable to support any rights and remedies they might assert with respect to commissions earned and paid or otherwise due to Russell Associates.

Canandaigua National interposed an Answer which alleged that: (1) as of August 14, 1996 Russell Associates owed Canandaigua National \$142,779.18, secured by a perfected security interest in all of the personal property of Russell Associates including, but not limited to, all accounts, inventory, general intangibles, chattel paper, documents of title, and instruments now owned or

thereafter acquired, and all proceeds thereof; (2) Canandaigua National's interest as a perfected secured creditor in any commissions earned by Russell Associates as the listing broker in connection with any of the Purchase and Sale Contracts was superior to any claims which could be asserted by either co-brokers or Salespersons, including Russell Associates Salespersons; and (3) Canandaigua National's interest as a perfected secured creditor in any commissions earned by Russell Associates as the selling broker in connection with any of the Purchase and Sale Contracts was superior to any claims which could be asserted by any co-brokers or Russell Associates Salespersons.

Moffett interposed an Answer which included, as Exhibit "A", a copy of a Greater Rochester Association of Realtors, Inc. Exclusive Right to Sell Contract (a "Listing Contract") and, as Exhibit B, a copy of a March 12, 1996 Russell Salesperson Agreement entered into between Russell Associates and William Heagney, (as an "Independent Contractor/Salesperson"), as a representative Agreement¹. Moffett's Answer asserted that: (1) in a transaction where Russell Associates was the listing broker and Moffett was the Russell Associates Salesperson, in order for her to earn a commission, she was required to: (a) obtain a ready, willing and able buyer; and (b) complete any necessary closing arrangements including, but not limited to, arrangements for the signing of the Purchase and Sale Contract, arranging an engineer's inspection, arranging for repairs to be completed, arranging for a mortgage appraisal and approval, setting up and attending a final walk-through, and changing utilities ("Post-Contract Activities"); and (2) under her Russell Associates Salesperson Agreement, Russell Associates was required to pay Moffett the commissions provided for after it had collected the commissions from the seller where Russell Associates was the listing

¹ At a hearing conducted on August 29, 1996, it was represented to the Court that the form used for all of the Russell Salespersons Agreements was the same form.

broker, or from a co-broker, where Russell Associates was the selling broker. Moffett's Answer also included three counterclaims, as follows: (1) pursuant to the provisions of the Listing Contract and the Russell Salespersons Agreement, Moffett's share of any commissions earned were not property of Russell Associates or the Russell Associates bankruptcy estate under Section 541; (2) the Listing Contract and the Purchase and Sale Contract for any given executory contracts under Section 365, which must be assumed by Russell Associates, and when assumed must be assumed in whole and not in part, since they constitute a unitary contract; (3) in connection with a Listing Contract and/or Purchase and Sale Contract assumed by Russell Associates pursuant to Section 365, Moffett, or the respective Russell Associates Salesperson, must receive their share of any commissions earned and ultimately paid to Russell Associates, because the Russell Salesperson Agreements are also part of the unitary contract comprised of the Listing Contract and the Purchase and Sale Contract; (4) in connection with the Vern Countryman test for determining whether contracts are executory, substantial performance remains due on both sides under the Listing and Purchase and Sales Contracts, which make them executory, and which requires Russell Associates to assume them under Section 365.

On August 16, 1996, the attorneys for Moffett filed a Memorandum of Law (the "Moffett Memorandum") in support of Moffett's assertions in their counterclaims that: (1) Salespersons shares of any earned and received commissions are not property of a debtor's estate; (2) the Listing Contract, Purchase and Sale Contract, and Russell Sales Person Agreements for any given transaction constitute a unitary contract under New York law; (3) this unitary contract is an executory contract which Russell Associates is required to assume under Section 365, with Court

approval; and (4) once this unitary contract is assumed, the bankruptcy estate of Russell Associates would be required to pay to any co-broker and Russell Associates Salespersons an amount representing their share of any earned and received commissions and their rights to payment would be superior to the rights of Canandaigua National and the other unsecured creditors of Russell Associates.

At an August 9, 1996 at a preliminary hearing, Russell Associates requested that it be authorized under Section 363 to use cash collateral in which Canandaigua National had an interest, on August 19, 1996, at the pretrial conference conducted by the Court in connection with the Adversary Proceeding, and on August 21, 1996, the return date of various motions (the "Turnover Motions") brought on by Russell Associates for the turnover of various commissions being held by co-brokers and the attorneys for various sellers in connection with Purchase and Sale Contacts which had closed, the Court generally discussed with the interested parties present and their attorneys various legal positions regarding earned commissions. At the August 19, 1996 pretrial conference the Court: (1) adjourned the conference to August 29, 1996, a Chapter 11 calendar day; (2) instructed the parties to make any further submissions they wished to make in connection with the Moffett executory contract counterclaim before August 29, 1996; and (3) indicated that the Court would make a ruling on August 29, 1996 with respect to the Moffett executory contract counterclaim.

On August 27, 1996, the attorneys for Russell Associates filed a Memorandum of Law with respect to the executory contract counterclaim (the "Russell Associates Memorandum"), and on the same day Moffett filed an affidavit regarding the counterclaim (the "Moffett Affidavit").

On August 28, 1996, the Court received a letter from the attorney for a recently appointed creditors committee ("Creditors Committee #2"), consisting of unsecured creditors other than the brokers and Salespersons, which indicated that that Committee supported the position of Russell Associates that the contracts in questions were not executory contracts which were required or permitted to be assumed by Russell Associates pursuant to Section 365.

On August 29, 1996, the Court received a letter from the attorney for the Association which included a copy of a document entitled, "Recommended Guidelines for Real Estate Agents and Attorneys from Initial Contract/Listing to Transfer of Title in a Real Estate Transaction", in which the attorney for the Association advised the Court that these were guidelines developed through a joint and cooperative effort of the Association and Monroe County Bar Association.

On August 29, 1996, the Court heard oral argument in connection with the Moffett executory contract counterclaim from the attorney for Russell Associates, the attorneys for Moffett, who also represented a recently appointed creditors committee consisting of brokers and Salespersons ("Creditors Committee #1), the attorney for ReMax, the attorney for the Association, and various Russell Associates Salespersons.

On August 29, 1996, the Court issued a Decision & Order (the "Executory Contract Decision") which: (1) held that neither the Russell Salesperson Agreements, the Purchase and Sale Contracts, nor the Listing Contracts were executory contracts of the Debtor which the Debtor was permitted or required to assume or reject under Section 365; and (2) determined that since none of these Agreements individually were executory contracts which the Debtor was permitted or required to assume or reject under Section 365, it was not necessary for the Court to decide whether they

should be construed as one agreement under the Unitary Contract Doctrine. The Executory Contract Decision is currently on appeal to the United States District Court for the Western District of New York.

In its Executory Contract Decision, the Court set forth its understanding of a typical residential real estate purchase and sales transaction in the greater Rochester area, as follows:

“A seller goes to a licensed real estate broker’s office and enters into a Listing Contract with that real estate broker (the” Listing Broker”). The seller may have gone to that Listing Broker because of a particular Salesperson who works out of that Broker’s office, because of a past real estate transaction, because of a referral from an attorney, accountant, friend or neighbor, or for a variety of other reasons. In the Listing Contract the seller agrees to pay the Listing Broker’s office a negotiated “commission”, generally 6% of the ultimate selling price in the greater Rochester area, which is earned according to the Listing Contract, “when I am provided with a written purchase offer which meets the price and other conditions I have set or when the Purchase and Sale Contract becomes a binding legal commitment on the buyer“. The Listing Contract also states that, “[a]t the closing of the sale of the property, my representative (such as my attorney) is authorized to pay the Realtor (the Listing Broker) the commission agreed to in paragraph 4 from the proceeds of the sale of the property”. In addition, in the Listing Contract the seller authorizes the Listing Broker “to cooperate with other brokers including, brokers who represent buyers . . . [t]o appoint subagents, and to divide with other licensed brokers such compensation in any manner acceptable. I understand and agree that if the commission provided for in paragraph 4 is divided, it will be divided as follows” (customarily 3% to the listing office and 3% to a selling broker’s office in the greater Rochester area).

Once the Listing Contract is entered into, the property is multiple-listed through the Association, and ultimately when a buyer is obtained, the buyer and seller enter into a Purchase and Sale Contract. The Purchase and Sale Contract generally provides for a deposit (the “Deposit”) to be made with the Listing Broker, “which is to become part of the purchase price or returned if [the sale is] not completed or if Buyer’s contract thereafter fails to close for any reason not the fault of the Buyer.” The Purchase Contract also generally identifies the Selling Broker’s office by stating that, “the parties agreed that _____ brought about this purchase and sale”, and this blank is filled in with the selling broker’s name (the “Selling Broker”). A portion of the Purchase and Sale Contract, labeled as Administrative Information, sets out detailed information regarding the buyer, seller, the attorney for the buyer

and seller, selling broker, listing broker, selling agent (Salesperson), and listing agent (Salesperson).

Recently, more and more Purchase and Sale Contracts have been made contingent upon engineering inspections, radon inspections, and carbon-monoxide inspections, in addition to such traditional contingencies as the buyer needing to sell its current residence or obtain a mortgage from a financial institution.

In addition, at the time the Purchase and Sale Contract is entered into the buyer, seller, listing Salesperson and selling Salespersons enter into a Disclosure Regarding a Real Estate Agency Relationship (the "Disclosure Statement").

Typically, after the Purchase and Sale Contract is entered into, copies are forwarded to the attorneys for the buyer and seller, various contingencies are worked on by the parties, Salespersons, and attorneys, and if and when all contingencies are removed or waived, a closing is scheduled, typically with the attorney for the lending institution from which the buyer is obtaining a mortgage.

At the time of closing, if the Deposit is not sufficient to cover the entire commission agreed to be paid to the Listing Broker in the Listing Contract, the Listing Broker, in accordance with the authorization contained in the Listing Contract, generally forwards a statement for the balance of any commission due to the attorney for the seller. At the time of closing the attorney for the seller will then see that this amount is paid to the Listing Broker from the proceeds of sale so that his client, the seller, will have fulfilled his obligations under the Listing Agreement. The Court has been advised, however, that in some real estate transactions in the greater Rochester area, the attorney for the seller may receive two statements, a statement from the Listing Broker for the balance of its divided commission (typically 3% less the Deposit), and a statement from the Selling Broker for its typically 3%. Once earned commissions are received by a Broker after the closing, whether the Broker was the Listing or Selling Broker to the transaction, that Broker then pays to any Salespersons in its office who worked on the transaction an amount computed in accordance with the Broker's agreement with that Salesperson. The Russell Salesperson Agreement incorporates a sliding scale of commissions to which a Russell Associates Salesperson may be entitled in connection with a listing or sale which appears to run from a low of 27% of the Russell Associates share of a commission earned and paid to a high of 70%.

On August 27, 1996, Canandaigua National filed a Motion for Summary Judgment, made returnable on September 4, 1996, (the "Canandaigua National Motion") which requested that the

Court determine that: (1) the entire gross commission (a “Listing Commission”) due Russell Associates under a Listing Contract where it was the listing broker was property of the estate under Section 541; (2) the entire gross commission (a “Selling Commission”) due Russell Associates as the selling broker in connection with a Purchase and Sale Contract was property of the estate under Section 541; (3) Canandaigua National had a perfected security interest in and lien on all Listing Commissions due Russell Associates which was superior to any claim or interest which any selling broker or listing or selling salesperson, including a Russell Associates Salesperson, might claim in such Commissions; (4) Canandaigua National had a perfected security interest in and lien on all Selling Commissions due Russell Associates which was superior to any claim or interest which any Russell Associates Salesperson might claim in such Commissions; and (5) the Listing and Selling Commissions due Russell Associates should be paid over to Canandaigua National as the same were received, until the Canandaigua National indebtedness was paid in full, together with all accrued and accruing interest and expenses.

In connection with the Turnover Motions made by Russell Associates, the Court had ruled that parties holding Selling Commissions due Russell Associates must turn over those Commissions to the attorneys for Russell Associates, but that the turnover would specifically be without prejudice to the claim of any listing broker that it had a right to offset those Selling Commissions against Selling Commissions it was entitled to on other Purchase and Sale Contracts where Russell had received or would receive all of the Commissions as Listing Commissions where Russell Associates was the listing broker (the “Setoff Model”). As part of the hearings on those Turnover Motions, the pretrial conferences conducted by the Court in the Adversary Proceeding and the oral argument on

August 29, 1996 in connection with the Moffett executory contract counterclaim, the Court agreed to determine, as part of its ruling on the Canandaigua National Motion: (1) whether other brokers, had a right of setoff under the Setoff Model; and (2) whether such right of setoff was superior to the perfected security interest of Canandaigua National in the Selling Commissions due Russell Associates under the Setoff Model.

In addition, as part of the Turnover Motions, the pretrial conferences conducted in the Adversary Proceeding, and the oral argument on the Moffett executory contract counterclaim, the Court agreed to determine, as part of its ruling on the Canandaigua National Motion, whether any broker, except to the extent that it had setoff rights, Russell Salesperson or other Salesperson had any interest or claim to the Listing and Selling Commissions due Russell Associates superior to the interests and claims of the other unsecured creditors of Russell Associates.

On August 28, 1996, Russell Associates filed a cross-motion (the "Russell Cross-Motion") for an order granting summary judgment which requested that the Court determine that: (1) Canandaigua National had a perfected security interest in all Listing and Selling Commissions due Russell Associates; (2) in connection with Listing Commissions due Russell Associates, no selling broker or Salesperson associated with that selling broker, had a lien on, right to receive or claim to those Commissions which was superior to the claim of Russell Associates as the listing broker, and that the claim of any such selling broker or Salesperson associated with the selling broker were not entitled to any priority under Section 507; (3) in connection with Listing Commissions due Russell Associates, no Russell Associates Salesperson had a lien on, right to receive or claim to those Commissions superior to the lien of Canandaigua National, and no lien on, right to receive or claim

to them superior to the Russell Associates bankruptcy estate; (4) any claim which a Russell Associates Salesperson might have in Listing or Selling Commissions might be entitled to a \$4,000.00 priority under Section 507(a)(3)(B), to the extent that such Russell Associates Salesperson could otherwise meet the requirements of that subsection; and (5) no Russell Associates Salesperson had any right of setoff against Russell Associates or its estate under Section 553.

On August 30, 1996, the attorney for Creditors Committee #2, filed a letter with the Court which raised a concern as to whether the perfected security interest of Canandaigua National might be subject to subordination under Section 510, to the extent that officers or representatives of Canandaigua National may have participated with the principal of Russell Associates to delay the Chapter 11 filing so that Canandaigua National's Uniform Commercial Code filings on March 29, 1996, filed over three months after the loan was made on or about January 5, 1996, could become perfected for more than ninety days, and thus not be avoidable under Section 547.

On August 30, 1996, a Memorandum of Law was filed with the Court on behalf of defendant Mary Moffett and Creditors Committee #1, (the "Committee Memorandum"). The Committee Memorandum asserted that: (1) Canandaigua National did not have a perfected security interest in Listing or Selling Commissions due Russell Associates which, because such Commissions were a contract right under the New York Uniform Commercial Code, and Canandaigua National's security agreement and filings only covered accounts and general intangibles, not contract rights; (2) the Commissions due to selling brokers and Russell Salespersons were not property of the bankruptcy estate under Section 541, but were the property of those brokers and Salespersons since they, not Russell Associates, earned those Commissions, and the relevant agreements speak in terms of

dividing and distributing Commissions rather than paying them; (3) because other selling brokers and Russell Associates Salespersons own their respective shares of any Listing and Selling Commissions due Russell Associates under the relevant agreements, and such Commissions are not property of the bankruptcy estate, Canandaigua National did not have a lien on those shares of the Listing and Selling Commissions; and (4) Section 442-A of the New York Real Property Law requires that all commissions earned by Salespersons must first be collected by brokers in order to protect the public from unlicensed salespeople, but it does not intend to address the ownership interests in the commissions as between the broker and the Salesperson.

On the return date of the Canandaigua National Motion the Court heard oral argument, reserved decision and gave the parties until September 13, 1996 to make voluntary submissions, and later extended the time of Canandaigua National to September 17, 1996 to make a voluntary submission on the Section 553 setoff issue.

At oral argument on September 4, 1996, it was asserted: (1) by the attorneys for Canandaigua National, that Canandaigua National's security agreement and filings covered general intangibles and accounts, the Commissions due a licensed real estate broker such as Russell Associates were clearly either accounts or general intangibles and the 1978 Amendments to the New York Uniform Commercial Code deleted contract rights as a separate item of collateral; (2) by the attorneys for Canandaigua National, that in connection with any allegations that all or any part of the Canandaigua National indebtedness should be subordinated under Section 510 because Canandaigua National and the principal of Russell Associates cooperated in extending the time of the bankruptcy filing so that Canandaigua National's security interest could be perfected and unavoidable under Section 547,

none of the responsible Canandaigua National officers were aware in advance of a potential bankruptcy filing; (3) by the attorneys for Canandaigua National, that Canandaigua National's perfected security interest in the Listing and Selling Commissions due Russell Associates was superior to any right of setoff which another listing broker might have under the Setoff Model; (4) by the attorneys for Moffett and Creditors Committee #1, that the Commissions due the selling brokers and Russell Associates Salespersons were not property of the bankruptcy estate under Section 541, were owned by those selling brokers and Russell Associates Salespersons, and that even though the attorneys could find no definitive statutory or case law to support those allegations, Russell Associates own accounting practices, which listed total company dollars (net commissions) rather than gross commissions on transactions, supported the allegation that the Commissions due other brokers and Russell Associates Salespersons were not property of Russell Associates or its bankruptcy estate; (5) by the attorneys for Moffett and Creditors Committee #1, that fairness required that brokers and Salespersons, including Russell Associates Salespersons, receive their full share of all Listing and Selling Commissions, since they were the ones who earned those Commissions; (6) by the attorneys for Russell Associates, that other brokers under the Setoff Model did have a right of setoff under Section 553; (7) by the attorneys for Russell Associates, that Real Property Law Section 442-A prevents Russell Associates Salespersons, or any Salespersons, from having a direct right to Commissions; (8) by the attorneys for Russell Associates, that absent any other agreement in connection with a given transaction, the Listing Contract and Purchase and Sale Contract require the Court to conclude that the only party entitled to be paid and receive Commissions in the first instance is the listing broker; (9) by the attorneys for Russell Associates, that the definition of

property of the estate under Section 541 is intentionally broad, and includes Listing and Selling Commissions due Russell Associates; (10) by the attorneys for Russell Associates, that there is no statutory or case law which it could find which supports the proposition that selling brokers or Russell Associates Salespersons have a right to Commissions to be paid pursuant to Listing Contracts on which Russell Associates was the listing broker which were superior to the rights of Russell Associates and its estate to those Commissions; (11) by the attorneys for Russell Associates, that any deposits to be held by Russell Associates as a listing broker pursuant to the Purchase and Sale Contracts were not being held on behalf of any selling brokers or Salespersons, including Russell Associates Salespersons; and (12) by the attorney for Russell Associates that approximately \$100,000 of the \$150,000 loan obtained from Canandaigua National in January, 1996 was used by Russell Associates to pay overdue amounts, as commissions, to other brokers and Russell Associates Salespersons; and (13) by the attorneys for Russell Associates, that fairness required that Listing and Selling Commissions due to Russell Associates be shared, after payment of the amounts due to Canandaigua National which had a first perfected security interest in the Commissions, by all of the creditors of Russell Associates equally, except for any priorities set forth in Section 507.

On September 5, 1996, Russell Associates filed a Memorandum of Law (the "Russell Memorandum") in support of the Russell Cross-Motion. On September 12, 1996, Canandaigua National filed the Affidavits of four bank officers indicating that they did not know in advance about the Russell Associates bankruptcy filing. On September 16, 1996, Canandaigua National's attorneys filed a letter indicating that Canandaigua National was no longer contesting that other listing brokers

under the Setoff Model had setoff rights which were superior to the rights of Canandaigua National as a perfected secured creditor.

DISCUSSION

I. SETOFF RIGHTS OF CO-BROKERS

Section 553(a) provides in part that:

- (a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title 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 this title against a claim of such creditor against the debtor that arose before the commencement of the case....

As part of the Court's prior rulings on the Turnover Motions and the requests by Russell Associates to use cash collateral, the Court determined that the Listing and Selling Commissions due Russell Associates were all earned prepetition when the prepetition Purchase and Sale Contracts were entered into. Consistent with that ruling and for the purposes of determining mutuality under Section 553, it follows that the rights and obligations of other brokers under those Purchase and Sale Contracts and the related Listing Contracts also arose prepetition. In addition, the rights and obligations regarding the payment of Commissions between Russell Associates and the other brokers under those prepetition Contracts must be considered in the aggregate and not on a Contract by Contract basis. Therefore, mutual debts and claims arose between Russell Associates and the other brokers who acted as listing or selling brokers in connection with the Purchase and Sale Contracts, and listing brokers under the Setoff Model do have valid rights of setoff under Section 553. Both

Russell Associates and Canandaigua National have now conceded these rights of setoff, and neither Creditors Committee #1 or #2, nor any other defendant in the Adversary Proceeding, has contested them.

However, Section 362(a)(7) prohibits a creditor which asserts a right of setoff under Section 553 from implementing any setoff unless the creditor first obtains relief from the stay. Because of the unusual circumstances of this case, the Court will enter orders permitting a broker to implement a setoff under the Setoff Model based on motions made by brokers with valid rights of setoff, and also will enter ex parte orders provided that the ex parte orders are consented to by the attorneys for Russell Associates (or any trustee appointed for Russell Associates), both of the Creditors Committees and Canandaigua National.

II. THE SECURITY INTEREST OF CANANDAIGUA NATIONAL IN LISTING AND SELLING COMMISSIONS

_____From the papers filed by Canandaigua National in the Adversary Proceeding and the cash collateral hearings, I find that Canandaigua National, to secure the indebtedness due from Russell Associates, has a perfected security interest in all of the personal property of Russell Associates, including Listing and Selling Commissions due Russell Associates. These Commissions are accounts² under Section 9-106 of the New York Uniform Commercial Code (the “UCC”), in which

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Section 9-106 defines “Account” as any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance. A 1972 Amendment, effective in New York on July 2, 1978, eliminated, as unnecessary and otherwise confusing, contract rights as a separately defined item of collateral.

Canandaigua National has a perfected security interest by reason of the security agreements signed by Russell Associates and the financing statement filings made by Canandaigua National pursuant to the requirements of the UCC. As discussed above, however, the perfected security interest of Canandaigua National in the Listing and Selling Commissions due Russell Associates is subject to any valid rights of setoff which any other listing broker may have under the Setoff Model.

The attorney for Creditors Committee #2 has raised as an issue for determination the possible subordination under Section 510 of all or a portion of the perfected security interest of Canandaigua National. Because it is still early in the case, the Court will allow both Creditors Committees sixty (60) days from the date of the entry of this Decision & Order to further investigate any possible subordination of the Canandaigua National perfected security interest and to commence an adversary proceeding, as required by Rule 7001(8), if either Committee believes that after its good faith investigation such an adversary proceeding would be appropriate. In addition, the Court will allow any trustee appointed in the Russell Associates bankruptcy case thirty (30) days from the date of his or her appointment to commence such an adversary proceeding, unless that time is otherwise extended by a further Court order.

_____ Canandaigua National is authorized to work with the attorneys for Russell Associates or any trustee to be paid the amounts due it from the Listing and Selling Commissions received by Russell Associates, after provision has been made for: (1) the payment of the expenses of administration in the Russell Associates case, as authorized by the Orders of this Court approving the use of cash collateral; and (2) the implementation of any setoff rights by other brokers. Payments to

Canandaigua National may be recoverable, in whole or in part, if any adversary proceeding for subordination under Section 510 and Rule 7001(8) is filed and ultimately successful.

III. ARE THE LISTING AND SELLING COMMISSIONS DUE RUSSELL ASSOCIATES PROPERTY OF THE ESTATE UNDER SECTION 541?

The Court finds that: (1) all gross Listing and Selling Commissions due Russell Associates are property of the estate under Section 541; (2) the obligation of Russell Associates, as a listing broker, to pay an amount designated as commissions to any selling broker or Russell Associates Salesperson for services they performed in connection with the underlying purchase and sale gives those brokers and Russell Associates Salespersons a general unsecured claim only; and (3) the obligation of Russell Associates, as a selling broker, to pay an amount designated as commissions to any Russell Associates Salesperson for services he or she performed in connection with the underlying purchase and sale gives those Russell Associates Salespersons a general unsecured claim only.

As set forth above, these gross Listing and Selling Commissions, as property of the estate under Section 541, are nevertheless subject to: (1) the perfected security interest of Canandaigua National; and (2) any rights of setoff in favor of other brokers under the Setoff Model.

A. Section 541.

Section 541(a)(1) and (2) provide that:

- (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

- (1) Except as provided in subsections (b) and (c)(2) of this section, all legal or equitable interest of the debtor in property as of the commencement of the case.
- (2) All interests of the debtor and the debtor's spouse in community property as of the commencement of the case that is—
 - (A) under the sole, equal or joint management and control of the debtor; or
 - (B) liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

It is clear that Congress intended the definition of property of the estate under Section 541(a) to be extremely broad. As set forth above, the gross Listing and Selling Commissions due Russell Associates are accounts under Section 9-106 of the UCC because they represent a right to payment for services rendered under the pertinent agreements (Purchase and Sale and Listing Contracts) and the custom in the real estate business as it is conducted in the greater Rochester area. Furthermore, the Court has determined that this right to payment was earned by Russell Associates, as a licensed real estate broker, when the underlying Purchase and Sale Contracts were entered into between the buyer and the seller.³

Therefore, the gross Listing and Selling Commissions due Russell Associates are property of the estate under Section 541 unless other brokers, as selling brokers in a transaction, or Russell Associates Salespersons, as Salespersons, have a superior right to these Commissions. As analyzed

³ See *Denton v. Anderson*, 178 F.2d 841 (2d Cir. 1949) and *Lane-Real Estate Dept. Store v. Lawlet Corp.*, 28 N.Y.2d 36 (1971), as discussed in the Russell Memorandum.

below, the Court does not believe that selling brokers or Russell Associates Salespersons have such a superior legal or equitable right.

B. The Rights of Selling Brokers to Be Paid Commissions by Russell Associates as a Listing Broker.

The licensed real estate brokers in the greater Rochester area have elected to participate with each other in a transactional system where the prospective seller of real estate enters into a Listing Contract which provides that all contractual commissions due in connection with the sale of his or her property are payable only to the listing broker (see Paragraph 4 of the Listing Contract). Although Paragraph 5 of the Listing Contract authorizes the listing broker to cooperate with other brokers and to divide compensation with other licensed brokers, sometimes in specific percentages, it is only the listing broker which is entitled to be paid and to receive the contractual commissions. Although in the Purchase and Sale Contract the selling broker is identified, in the greater Rochester area, unlike in some other areas, no subsequent agreement is entered into which obligates the seller to pay any portion of the contractual commissions set forth in the Listing Contract directly to the now identified selling broker.

As a result, it appears that the licensed real estate brokers in the greater Rochester area, when they act as a selling broker, look to the credit of the listing broker to pay them for their services at or after the closing.

Neither Remax, any other broker who has participated in the Adversary Proceeding, nor Creditors Committee #1 has provided the Court with any other written agreement, statute, or court decision which indicates that a selling broker in the greater Rochester area has a right superior to the

right of the listing broker to be paid by or receive from the seller or its representative any portion of the commissions due under the Listing and Purchase and Sale Contracts.

Therefore, the Court finds that, pursuant to the Listing Contract, the Purchase and Sale Contract and the custom among brokers in the greater Rochester area, the claim of a selling broker to be paid for its services an amount, designated as commissions, in connection with a purchase and sale, is a general unsecured claim against the listing broker. However, as set forth above, that selling broker as a listing broker in other transactions may have a right of setoff under the Setoff Model.

C. The Rights of Russell Associates Salespersons.

_____Moffett and Creditors Committee #1 have asserted that Russell Associates Salespersons have an ownership interest in the portion of the Listing and Selling Commissions due Russell Associates which is equivalent to the percentage due to them under their respective Russell Salesperson Agreement, and that that ownership interest in the Commissions is superior to the rights of Russell Associates, Canandaigua National, as a perfected secured creditor, and the other creditors of the Russell Associates bankruptcy estate.

For the following reasons the Court finds that the claims of Russell Associates Salespersons to be paid a portion of the Listing and Selling Commissions received by Russell Associates in connection with purchases and sales where that Salesperson performed services, are unsecured claims which are not superior to the rights and claims of the Russell Associates bankruptcy estate, Canandaigua National, as a perfected secured creditor, or the other general unsecured creditors:⁴

⁴ As discussed later, these Salespersons may have an allowed priority unsecured claim up to the amount of \$4,000.00 pursuant to Section 507(a)(3)(B).

- (1) Neither the Listing Contract, nor the Purchase and Sale Contract directly or indirectly provide for the payment of commissions to any Salesperson. Paragraphs 4 and 5 of the Listing Contract only require that the seller pay commissions to the listing broker, and suggest that there may be a division of commissions among the listing broker and other licensed brokers. This is consistent with Section 442-a of the New York Real Property Law which provides that:

“No real estate salesman in any place in which this article is applicable shall receive or demand compensation of any kind from any person, other than a duly licensed real estate broker with whom he associated, for any service rendered or work done by such salesman in the appraising, buying, selling, exchanging, leasing, renting or negotiating of a loan upon any real estate.”

- (2) Case law in New York State, as cited to the Court in the Russell Memorandum, indicates that as between a Salesperson and a judgment creditor of the licensed broker with which that Salesperson is associated, the judgement creditor has a superior right to the commissions payable to the broker in connection with a purchase and sale transaction⁵. Furthermore, Russell Associates, as a debtor in possession, for the benefit of all of the creditors of the bankruptcy estate, has the rights and powers of a trustee under Section 544, which rights and powers include those of a judicial lien creditor at the time of the filing of the petition (commonly referred to as the rights of a “perfect lien creditor”).⁶

⁵ *Reed v. Karp*, 174 A. D. 2d 659 (2d Dept. 1991).

⁶ Section 544 provides in pertinent part:

- (a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer or property of the debtor or any obligation incurred by the debtor that is voidable by—

- (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that

- (3) The Russell Salesperson Agreement is an independent contractor Agreement which does not in any way require Russell Associates, as a licensed real estate broker, to hold the amounts which it receives as Listing or Selling Commissions in trust for the Salesperson, nor does the Agreement grant the respective Salesperson any purported ownership interest in or lien on those Commissions. These Agreements variously provide for the payment of Commissions (Paragraphs 4 and 7) and the division and distribution of commissions (Paragraph 14), indicating that the Salesperson has only a claim to be paid an amount computed by reference to the Commission received by Russell Associates and a percentage due that Salesperson as provided for in their particular Agreement.
- (4) No interested party has provided the Court with any other written agreement, statute, court decision or theory, other than fundamental fairness, which would support the allegation that Russell Associates Salespersons are entitled to a portion of any Listing or Selling Commissions other than as general unsecured creditors.
- (5) There is nothing about licensed real estate salespersons acting as independent contractors under independent contractor agreements with licensed real estate brokers in New York State, necessitated in part by the framework imposed by New York State on residential real estate transactions, which makes such salespersons/ independent contractors distinguishable from the class of independent contractors

obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

- (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists.

which Congress has elected to protect to the extent provided under Section 507(a)(3)(B).⁷

IV. THE RIGHTS OF BROKERS AND RUSSELL ASSOCIATES SALESPERSONS UNDER SECTION 507(a)(3)(B).

In the 1994 Amendments to the Bankruptcy Code⁸, Congress amended Section 507 to expand it to include a priority claim for up to \$4,000.00 for sales commissions earned within ninety days of the petition by certain independent contractors. Assuming that they can otherwise meet the requirements of this subsection with respect to the percentage of income earned within the preceding twelve months, Russell Associates Salespersons and licensed brokers directly associated with Russell Associates would be entitled to a priority claim of up to \$4,000.00 which would be paid ahead of other general non-priority unsecured creditors if there are sufficient funds available.

⁷ Section 507(a)(3)(B) provides:

The following expenses and claims have priority in the following order:

- (3) Third, allowed unsecured claims, but only to the extent of \$4,000 for each individual or corporation, as the case may be, earned within 90 days before the date of the filing of the petition or the date of the cessation of the debtor's business, whichever occurs first, for
 - (B) sales commissions earned by an individual or by a corporation with only 1 employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business if, and only if, during the 12 months preceding that date, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor.

⁸ Pub. L. No. 103-394 (1994).

Although in this case the priority afforded Russell Associates Salespersons and directly associated licensed brokers, if any, may not fully compensate them for the financial loss which they may experience, this is what Congress has provided for independent contractor/Salespersons due Commissions.

V. FUNDAMENTAL FAIRNESS.

Selling brokers and Russell Associates Salespersons have asserted to the Court that it is fundamentally fair that they be paid all of the Commissions that are due them because they, not Russell Associates, earned those Commissions, and further, because the negative financial impact upon them, especially the Russell Associates Salespersons, would be much greater than upon any other creditors of Russell Associates.

As set forth in this Decision & Order, it appears to this Court that the law is clear that the Russell Associates Salespersons have no greater legal rights to the Listing and Selling Commissions due Russell Associates than the rights of the other prepetition unsecured creditors of Russell Associates.

This is because: (1) under Section 442-a of the New York Real Property Law Salespersons have no direct rights to commissions, but can only receive them through a licensed real estate broker; (2) the New York State Appellate Courts have determined that as between a judgment creditor of a broker and a Salesperson, the judgment creditor of the broker has priority in any commissions payable to the broker (*See Reed v. Karp*, 174 A.D.2d 659 (2d Dept. 1991)); (3) Congress in Section 544 has deemed a debtor in possession in a Chapter 11 case, upon the filing of its petition, to have the rights and powers of a perfect judgment lien creditor, in order to maximize the bankruptcy estate

for all of the creditors in furtherance of one of the fundamental policies of the Bankruptcy Code, which is equality of distribution among creditors, designed to fairly spread the risk of a business failure among the entities involved with the failed business; and (4) neither the written agreements used in the purchase and sale of real estate in the greater Rochester area, nor the Russell Salesperson Agreement, clearly affords the Salespersons an ownership, lien or priority interest in the Listing and Selling Commissions due Russell Associates.

Furthermore, it is clear that Congress anticipated the potential hardship to certain independent contractors who earn commissions as part of their dealings with a business if that business fails owing them commissions, and Congress protected them to the extent provided in Section 507(a)(3)(B) by giving them a priority unsecured claim of up to \$4,000.00.

In a decision written by then Chief District Judge Michael A. Telesca, sitting by designation, the United States Court of Appeals for the Second Circuit in *F.D.I.C. v. Colonial Realty*, 966 F.2d 57 (2d Cir. 1992), made it clear that a bankruptcy court may not use its power under Section 105(a)⁹ in a manner inconsistent with the commands of the Bankruptcy Code. In view of Sections 544 and 507(a)(3)(B), as analyzed in this Decision & Order, I believe that if I were to use my Section 105(a) powers to rule on an equitable basis that brokers and Russell Associates Salespersons should be paid

⁹ Section 105(a) provides that:

The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

their Commissions in full because that would be fundamentally fair, it would result in an abuse of my discretion because it would be a result which would be inconsistent with the commands of the Bankruptcy Code.

As discussed in the Executory Contract Decision, I am concerned for the hardship being experienced by the Russell Associates Salespersons. I would prefer that no business or individual ever financially fail and that all creditors always get paid. However, to handle the business and individual financial failures that do occur, Congress, by enacting the Bankruptcy Code and the Rules of Bankruptcy Procedure, has established what it believes is a comprehensive and fair bankruptcy system. In this system of laws, including applicable state law, it is the function of a Bankruptcy Judge to interpret and enforce the laws to insure fundamental fairness. However, if individuals or groups of individuals, such as the Russell Associates Salespersons, believe that the enforcement of the laws do not result in fundamental fairness, under our system of government they must seek to have the law changed by the legislative branch.

In their arguments on fundamental fairness presented to the Court at the various hearings conducted in this case to date, the Russell Associates Salespersons have emphasized what they believe is fair as between them and Russell Associates and its principal, Richard Russell. To the contrary, the attorneys for Russell Associates have stressed fundamental fairness as between the Russell Associates Salespersons and the other creditors of Russell Associates who also provided valuable goods and services to the business which allowed it to continue for as long as it did. The bankruptcy system did not participate in the Russell Associates business failure. However, once a petition is filed, one of the goals of the bankruptcy court and the other interested parties is to

