UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF WISCONSIN

In re:

MATRIX INTERIOR SUPPLY, INC., Case No. 95-21120

Debtor.

CHAPTER 7

PAUL G. SWANSON, TRUSTEE,

Plaintiff,

vs. Adversary No. 95-2516

FIRST AND PORTLAND CORPORATION and
PHOENIX LTD. DESIGN & CONSTRUCTION,

Defendants.

DECISION

INTRODUCTION

This adversary proceeding for recovery of an account receivable was brought by the Chapter 7 Trustee against the defendants First & Portland Corporation (1st & Portland) and Phoenix Limited Design & Construction (Phoenix). Various matters other than the receivable were previously contested by the parties. Prior to trial, however, all contested issues except setoff were resolved. No judgment is sought against 1st & Portland, but it was made a party because of the alleged assignment to Phoenix of its claim against the debtor.

There are differences of opinion among courts regarding whether the recovery of a contested receivable is a core proceeding, although in this case the determination of the amount

owed the debtor is tied to the claim of 1st & Portland. *See* 28 U.S.C. § 157(b)(2)(O). The determination of a claim is a core proceeding. 28 U.S.C. § 157(b)(2)(B). Nevertheless, both parties agreed on the record before trial that this court can resolve this controversy and enter a final order. 28 U.S.C. § 157(c)(2).

This memorandum decision constitutes the court's findings of fact and conclusions of law pursuant to Fed. R. Bankr. P. 7052.

FACTS

The debtor, Matrix Interior Supply, Inc., filed a voluntary petition for relief under Chapter 7 of the Bankruptcy Code on March 1, 1995. The Chapter 7 Trustee then filed an adversary proceeding seeking, among other things, turnover of an account receivable for outstanding invoices from defendant Phoenix.

Defendants 1st & Portland and Phoenix are sister subsidiary corporations of HWGA, Inc. 1st & Portland owns and rents real estate properties. Phoenix performs construction and design work for 1st & Portland. Neither corporation has employees, a payroll, or offers benefits as all operations are directed by HWGA through its owner and sole shareholder, Leonard Hughes. The corporations were set up this way for tax purposes on the advice of Mr. Hughes' accountant. Tax returns are consolidated when filed. No financial statements, consolidated or separate, are prepared for either subsidiary corporation.

On April 8, 1994, Matrix and 1st & Portland executed a Lease Agreement for approximately 1,500 square feet of office space located in Fond du Lac, Wisconsin. The terms of the lease required Matrix to pay 1st & Portland $1,031.25 per month, commencing June 1, 1994.

Matrix vacated the premises without ever paying rent when it went out of business the following March upon the filing of its bankruptcy petition.

While Matrix occupied the 1st & Portland property, Phoenix was purchasing materials from Matrix for various construction projects. After deduction for agreed credits and setoffs, the parties filed an agreement that Phoenix owes Matrix $7,228.32, without deduction for the disputed setoff that is the focus of this litigation. Phoenix refused to pay Matrix for the outstanding invoices despite repeated demand from Matrix and the Chapter 7 Trustee.

1st & Portland is indebted to its sister corporation, Phoenix, in an amount in excess of $900,000. When it became apparent to Mr. Hughes and his controller that Matrix was not going to be paying rent to 1st & Portland in 1994 and 1995, 1st & Portland assigned the rent claim to Phoenix instead of commencing an eviction action against Matrix. Phoenix, in turn, offset the unpaid rent against indebtedness it owed to Matrix.

At trial, Mr. Peter Finn, who was Matrix' office and sales manager but not a corporate officer, stated that he never personally agreed to any offset arrangement. He admitted, however, that he did discuss the matter with Ms. Patricia Birschbach, the controller at HWGA, Inc. Ms. Birschbach claimed that she reached an agreement with Mr. Finn that setoff was acceptable to Matrix. Mr. William Murphy, president of Matrix, testified that he was not aware of any agreement, oral or written, to offset the debts.

Matrix did not keep an accounts payable for rent on its books. 1st & Portland is shown as a creditor on Matrix' bankruptcy schedules, but Mr. Finn stated he took the amount from a rent invoice.

ARGUMENTS

Both parties agree that Phoenix owes Matrix, Matrix owes 1st & Portland, and 1st & Portland owes Phoenix. Nevertheless, Phoenix contends it has been assigned the Matrix debt to 1st & Portland, and it can deduct this debt from amounts it owes Matrix. It claims Phoenix and 1st & Portland internally agreed to offset the debts, and because of the close triangular association between the entities, setoff should be allowed. Matrix contends that the entities are separate and setoff is not appropriate under 11 U.S.C. § 553.

DISCUSSION

Section 553 of the Code governs setoff. It provides, in part:

> (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, except to the extent that—
>
> (1) the claim of such creditor against the debtor is disallowed;
>
> (2) such claim was transferred, by an entity other than the debtor, to such creditor—
>
> (A) after the commencement of the case; or
>
> (B) (i) after 90 days before the date of the filing of the petition; and
>
> (ii) while the debtor was insolvent; or
>
> (3) the debt owed to the debtor by such creditor was incurred by such creditor—
>
> (A) after 90 days before the date of the filing of the petition;
>
> (B) while the debtor was insolvent; and
>
> (C) for the purpose of obtaining a right of setoff against the debtor.

11 U.S.C. § 553(a). The Bankruptcy Code does not itself create a right of setoff. Instead, it preserves the pre-existing common law right to setoff, subject to some limitations in the bankruptcy context. *Citizens Bank of Maryland v. Strumpf*, 116 S.Ct. 286, 289 (1995). In Wisconsin, the doctrine of setoff is well recognized. *See Zweck v. D P Way Corp.*, 70 Wis. 2d

426, 433-34, 234 N.W.2d 921, 925 (1975); *Mattek v. Hoffmann*, 272 Wis. 503, 506, 76 N.W.2d 300, 302 (1956). The Wisconsin Court of Appeals has noted that "[s]etoff is a mode which equity adopts to compel the ultimate payment of a debt by one who in justice, equity and good conscience ought to pay it." *O'Brien v. Freiley*, 130 Wis. 2d 174, 180 n. 4, 387 N.W.2d 85, 88 n.4 (Ct. App. 1986) (citing 20 Am. Jur. 2d *Counterclaim, Recoupment, and Setoff* § 6 (1965)).

If setoff is available under nonbankruptcy law, the court must determine whether setoff is available under § 553 of the Code. The right to setoff is permissive, not mandatory. Thus, its application rests within the discretion of the court. *In re Pyramid Industries, Inc.*, 170 B.R. 974, 982 (Bankr. N.D. Ill. 1994). Section 553(a) requires that (1) the creditor owes a debt to the debtor arising prepetition; (2) the creditor has a claim against the debtor arising prepetition; and (3) both the debt and the claim are mutual obligations. 11 U.S.C. § 553(a); *Pyramid Industries,* 170 B.R. at 982. The parties agree that Phoenix owes Matrix money and Matrix owes 1st & Portland, with both obligations arising prepetition. Thus, the court must determine whether the debt and claim are mutual obligations.

Mutuality exists only when the debts are in the same right and between the same parties, standing in the same capacity. *Darr v. Muratore*, 8 F.3d 854, 860 (1st Cir. 1993); *Boston & Maine Corp. v. Chicago Pac. Corp.*, 785 F.2d 562, 566 (7th Cir. 1986); 4 *Collier on Bankruptcy* ¶ 553.04[2] at 553-22 (15th ed. 1996). The mutuality requirement is strictly construed. *In re Hill Petroleum Co.*, 95 B.R. 404, 411 (Bankr. W.D. La. 1988). In general, one subsidiary may not offset a debt owed to a debtor against a debt owing from the debtor to another subsidiary. *Matter of Elcona Homes Corp.*, 863 F.2d 483, 486 (7th Cir. 1988); *Depositors Trust Co. of Augusta v. Frati Enters.*, 590 F.2d 377, 379 (1st Cir. 1979); *Pyramid Industries,* 170 B.R. at 982; *In re*

Balducci Oil Co., 33 B.R. 847, 852-53 (Bankr. D. Colo. 1983). Debts are not mutual when one party acquires a debt in its own right, but the other acquires the offsetting debt by assignment.

Various courts have carved out an exception to this general rule, however, and have allowed setoff in certain "triangular tradeoff" situations. *In re Hill Petroleum Co.*, 95 B.R. at 411; *Balducci Oil*, 33 B.R at 853. Mutuality between three parties may be found, as a matter of contract law, where there is an express contractual agreement clearly evincing the intent of the parties to treat the two nondebtor entities as one entity. *Hill Petroleum*, 95 B.R. at 411; *In re Ingersoll*, 90 B.R. 168, 171 (Bankr. W.D. N.C. 1987); *Balducci Oil,* 33 B.R. at 853 (citing *In re Berger Steel Co.*, 327 F.2d 401 (7th Cir. 1964)).

The burden of proof is on the creditor asserting that its triangular setoff right comes within the mutuality requirement of § 553, notwithstanding that the creditor's claim against the debtor was originally owed to a third party. *In re Metco Mining & Minerals, Inc.*, 171 B.R. 210, 216 (Bankr. W.D. Pa. 1994). Here, the creditor failed to carry this burden. Ms. Birschbach, controller for HWGA, testified that she reached an agreement with Mr. Finn that the offset was acceptable to Matrix. Mr. Finn recalled discussing it with her but denied agreeing to the setoff. Both were credible, but obviously there was no meeting of the minds between these individuals. Also, their conversations lack the formality of a binding contract. There was no evidence of any other formal agreement to assign and offset the debts among Phoenix, Matrix and 1st & Portland. Consequently, the lack of agreement means the obligations between the debtor and Phoenix are not mutual, and the arrangement does not fall within the narrow exception to the rule against three party setoffs. *Hill Petroleum*, 95 B.R. at 412 ("A debtor prior to bankruptcy may have

informally permitted a creditor to set of its obligations to the debtor against the debtor's debt to a related entity. However, such debts are not mutual.").

This result may not appear equitable to the defendants — after all, 1st & Portland abstained from evicting Matrix after the latter stopped paying rent. And treating Phoenix and 1st & Portland as a single entity makes sense because the owner treated them as parts of the same business, not as separate entities. However, the corporations' separate status arose to provide certain advantages for the owner and related corporations, presumably tax benefits and limited liability. It is not inequitable to treat them as separate entities when it is no longer quite as convenient. In other words, there are burdens as well as benefits incident to creating separate entities for various enterprises.

Even if equity favors setoff, principles of equity do not create mutuality when none exists. Furthermore, ignoring the bankruptcy requirement of mutuality because of equitable considerations is contrary to the position of the Seventh Circuit. The court in *Boston & Main Corp. v. Chicago Pacific Corp.*, 785 F.2d 562, 566 (7th Cir. 1986), held that there was no reason to enlarge the right to setoff beyond that allowed by § 553. Every setoff is a preference among creditors and "[s]ometimes the court may have compelling reasons not to allow that preference. But there is no justification for enlarging the preferential treatment beyond that provided by non-bankruptcy law or required by the bankruptcy code." *Id.* Thus, although this court may have the discretion to deny a setoff authorized by statute, it does not have discretion to grant a setoff not authorized by 11 U.S.C. § 553. *See Id.*

The triangular setoff of the debt and claim of subsidiary corporations is disallowed. The Trustee shall have judgment against Phoenix for $7,228.32, the full amount owed Matrix,

without setoff of 1st and Portland's claim against Matrix. 1st & Portland's claim shall not be reduced by any assignment of the claim to Phoenix. A separate order for judgment will be entered.

Dated at Milwaukee, Wisconsin, January 24, 1997.

BY THE COURT:

____/s/___________________________________
Honorable Margaret Dee McGarity
United States Bankruptcy Judge

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Defendants.

ORDER FOR JUDGMENT

For the reasons stated in the court's memorandum decision on this date, the Trustee is granted judgment against Phoenix Ltd. Design & Construction for $7,228.32.

Dated at Milwaukee, Wisconsin, January 24, 1997.

BY THE COURT:

_____/s/________________________________
Honorable Margaret Dee McGarity
United States Bankruptcy Judge

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