

UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

Paradigm Management Corporation,
Debtor.

CHAPTER 11

Bky. 3-94-3395

Paradigm Management Corporation,
Debtor In Possession,
Plaintiff,

vs.

Adv. No. 3-95-42

Commonwealth Construction Corp.,
Defendant.

ORDER

This matter was heard on August 16, 1995, on cross-motions for Summary Judgment. Appearances were noted in the record. The Court, having heard and received arguments; having reviewed the pleadings and relevant files; and, being fully advised in the matter; now makes this Order pursuant to the Federal and Local Rules of Bankruptcy Procedure.

I.

Paradigm Management Corporation (Paradigm) was in the business of managing properties that were developed by Gary Lefkowitz, through his corporation, Citi Equity Group. Citi Equity was the general partner of numerous limited partnerships that Mr. Lefkowitz formed to own more than 100 properties. Paradigm itself was owned by Mr. Lefkowitz, and controlled by him, until shortly after an involuntary bankruptcy was filed against Citi Equity on May 18, 1994.(FN1) Paradigm then became controlled by an independent manager, who also operated Citi Equity under a court approved agreement by interested parties.

Paradigm filed under Chapter 11 on July 25, 1994. During pendency of the case under Chapter 11, until sometime in March 1995, Paradigm managed property known as the Fox Run Apartment Complexes, pursuant to a management agreement with Citi-Fox Run Partners I and Citi-Fox Run Partners II (jointly referred to as "Citi-Fox"). Citi-Fox consisted of limited partnerships in which Citi-Equity was the general to payment equal to five percent of the gross rents collected from the Citi-Fox rental properties, as its management fee. (See: Property Management Agreement, section 5.1) Paradigm's responsibilities under the agreement were "[t]o collect rents . . . and to deposit all funds so collected in Paradigm's custodial account." (See: Property Management section 3.3.) The funds in Paradigm's custodial account were periodically transferred to a Citi-Fox bank account in California. Citi-Fox would then retain 95% of the proceeds and issue a check to Paradigm for the remaining 5%. (See: John D. Lathuras Affidavit para. 5).

In November 1994, Commonwealth Construction Corp. (Commonwealth) obtained default judgments against Citi-Fox in connection with construction of the properties. In December 1994, and January 1995, Commonwealth attempted to execute on the judgments against Citi-Fox, by commencing garnishment proceedings against Paradigm, in an effort to intercept the rents collected by Paradigm from the Citi-Fox properties' tenants.

The proceedings included an order, issued by the Court of Common Pleas of Delaware County, Ohio, that required Paradigm "to preserve, hold intact and deliver to the Delaware County Sheriff's Department, as and when received, all cash, checks, instruments and other documents received in satisfaction of rent due" Citi-Fox.

The order also required that if Paradigm had money, property, or credit "of such a nature that they cannot be delivered to the clerk . . . [then garnishee is not to] dispose of that money, property, or credit or give them to anyone else until further order of the court." Two separate garnishments were served on Paradigm, one in December 1994, and a second in January 1995.

Paradigm essentially ignored the garnishment orders. Paradigm continued to collect the rents, deposit them into the custodial account, and periodically send the funds in the account to Citi-Fox in the ordinary course, just as before the garnishments. The Debtor failed to respond to the garnishment proceedings, except to notify Commonwealth's attorneys by letter, dated February 6, 1995, that Paradigm had filed for bankruptcy; and, that the attorneys' "continuing actions on behalf of Commonwealth Construction Corp. to seize funds in which Paradigm has a direct interest as the management corporation for the properties, is a clear violation of the automatic stay provisions, 11 U.S.C. Section 362." This adversary proceeding was commenced by Paradigm on March 21, 1995, seeking declaratory judgment that the garnishment proceedings were in violation of the automatic stay, and are null and void.

Commonwealth responded by seeking an order from the state court finding Paradigm in contempt for refusal to comply with the garnishment orders. On April 27, 1995, a hearing was held on the contempt proceedings, a hearing was held on the contempt proceedings, and the state court issued a contempt order against Paradigm on May 15, 1995. The order stated that Paradigm was found to be in civil contempt for the "willful failure to complete and file its return . . . in response to the Garnishment Order and by failing to preserve all cash, instruments and other documents received by Paradigm in satisfaction of rent due Citi-Fox". Paradigm was again ordered by the Court of Common Pleas of Delaware County, Ohio, to account to Commonwealth and to the court for all cash, instruments and other documents received in satisfaction of rent due Citi-Fox, from from January to the time of the contempt order decree.

On July 11, 1995, Paradigm submitted, in this Court, its Memorandum In Support Of Its Motion For Summary Judgment. The motion itself was not filed until August 10, 1995. In the meantime, Commonwealth filed its own motion for summary judgment on August 2, 1995. Both motions were heard on August 16, 1995.

II.

Paradigm argues that the Citi-Fox rents received by it and deposited in the custodial account, were part of its bankruptcy estate; and that the rent proceeds were protected from collection efforts by the automatic stay of 11 U.S.C. Section 362. Commonwealth asserts that the garnishment orders required only that Paradigm report and deliver property that it held for Citi-Fox; and, that the rents were such property. Commonwealth claims that the collection effort was not against the estate or against estate property. Therefore, it asserts, no violation of the automatic stay occurred.

The automatic stay prohibits "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. Section 362(a)(3). The automatic stay prohibits collection efforts by creditors involving property of the estate. However, the stay does not prohibit acts to collect property of other parties held by a debtor; property in which neither the debtor nor the debtor's estate has any interest.

In this case, Paradigm has not shown that the estate had any interest in the Citi-Fox rents that were the subject of the garnishment proceedings. It is not clear from the record, to whom the rent checks were made payable by the tenants. But, Paradigm was required to deposit the checks into a custodial account, maintained for the benefit of

Citi-Fox. Funds held in a custodial account by a debtor for the benefit of third parties, do not ordinarily become estate property upon the debtor's filing bankruptcy. See: South Cent. Livestock Dealer's, Inc. v. Security State Bank, 614 F.2d 1056 (5th Cir. 1980).

Nothing has been shown about the arrangement here, that indicates that the Citi-Fox rents, or any part of them, ever belonged to Paradigm. The only evidence offered by Paradigm that might suggest that Paradigm had an interest in the rents, is an affidavit of John D. Lathuras, in which he says so.(FN2) But the statement is conclusory, not factual. Merely because Paradigm's compensation was calculated, based on the gross rents, did not mean that it had an interest in the rents themselves. The management agreement and the actual handling of the rents, clearly indicate that Paradigm had no interest in the funds.

Under the management agreement, Paradigm was required to periodically pay over the entire rent proceeds to Citi-Fox from the custodial account. Citi-Fox would then issue its check to Paradigm for an amount equalling 5% of the gross rents covered by Paradigm's remittance, as payment to Paradigm for its management services to Citi-Fox. Commonwealth's garnishment proceedings against Paradigm involved funds belonging solely to Citi-Fox, and did not violate the automatic stay of 11 U.S.C. Section 362.

III.

Based upon the forgoing, it is hereby ORDERED:

1. The garnishment proceedings against Paradigm, relating to Citi-Fox, judgment debtor, by Commonwealth, judgment creditor, were not in violation of the automatic stay under 11 U.S.C. Section 362;
2. The actions taken by Commonwealth in the Court of Common Pleas of Delaware County, Ohio, against Paradigm are not void.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: October 26, 1995.

By The Court:

Dennis D. O'Brien
Chief U.S. Bankruptcy Judge

(FN1) Mr. Lefkowitz has been indicted, and was later convicted, of 47 counts of fraud in connection with a scheme whereby he diverted tens of millions of dollars away from many of the properties.

(FN2) Mr. Lathuras is Vice President of Weybridge, Inc., the Court appointed managing agent for Citi Equity Group.