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From the Bankruptcy Courts

Benjamin Weintraub and Alan N. Resnick***

A Bank's Right to Place an Administrative Hold on a Debtor's Deposit Account Upon the Filing of a Bankruptcy Petition: An Issue Revisited

The automatic stay¹ is designed to protect a debtor-in-possession against any interference with its property by any entity until the bankruptcy court has had the opportunity of deciding the respective rights of the parties. In chapter 11, the stay plays an important role in allowing the debtor-in-possession (DIP) to maintain its business by continuing its manufacturing, selling its products, and utilizing its bank deposits in connection with its operations in accordance with the provisions of the Bankruptcy Code.

An old problem that concerns institutional lenders and DIPs has come to life again: To what extent may a bank freeze a DIP's bank account against which the bank has a prepetition right of setoff by indi-

cating in its record the simple words "administrative hold"? This designation is meant to render the account inactive until the bankruptcy court determines the rights of the parties to the deposit.^{1a}

A Simple Complication

In *In re Quality Interiors, Inc.*,² the bankruptcy court had for consideration a motion by Quality Interiors, Inc. (the DIP) for an order seeking to release the administrative hold by the Western Reserve Bank (Bank) of its bank accounts or in the alternative to use the cash collateral. Additionally, the court had for further consideration its previous order granting a replacement lien.³ The court treated the motion as a motion to use cash collateral and sustained it in part, subject to a final hearing on the use of cash collateral if the hearing was necessary.

The court began by characterizing the issues as "relatively simple" but "complicated by competing pol-

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¹ See 11 U.S.C. § 362.

^{1a} [Editor's Note: For a more extensive treatment of the judicial background to this problem, see the article in this issue at 228: Coleman, Garrett & Freidman, "Administrative Freeze: Creditor's Overreaching or Prudent Banking?"]

² 127 Bankr. 391 (Bankr. N.D. Ohio 1991).

³ *Id.* at 392.

icies of the Bankruptcy Code.”⁴ The issues were (1) whether an administrative freeze placed on the DIP’s account by the Bank constituted a violation of the automatic stay under Section 362 and (2) to what extent did the bank have a right of setoff in funds on deposit and to what extent did these funds constitute cash collateral under the Bankruptcy Code.

On October 23, 1990, Quality Interiors, a producer and installer of drywall and plaster, filed a petition under chapter 11. At that time, Quality Interiors maintained two deposit accounts at the Bank, a general operating account and a payroll account. Prior to filing, Quality Interiors was obligated to the Bank on outstanding note obligations that at the time of filing exceeded the aggregate amount of the two deposit accounts.

On the very next day, the DIP, following its weekly custom, transferred funds from its general account to its payroll account for payment of its payroll. This transfer was by check drawn by the DIP on its general account payable to “Quality Interiors, Inc. (Payroll Account)” in the amount of \$7,600. The payroll checks and one check drawn on the general account were subsequently returned to the DIP with notices of insufficient funds, even though the account balances exceeded the amount of the checks. The Bank had placed an “administrative hold” on both accounts.

⁴ *Id.*

Pursuant to an order of November 5, 1990, agreed to by the parties, each party submitted a brief with respect to the propriety of the administrative hold. In its brief, the DIP argued that the Bank had no right of setoff because the debts owing to the Bank had not yet matured, that with respect to the payroll account no right of setoff existed against the special deposits, and that the administrative hold violated the automatic stay under Section 362(a)(7).⁵ The Bank in response asserted that the DIP’s note obligations were in default and the Bank had a contractual right to set off the funds on deposit through the use of the administrative hold. The court observed that the first issue was whether the administrative hold violated the stay imposed by Section 362.

While this question is the subject of considerable debate, as discussed below, it should be noted first that the *setoff* of any debt *does* violate the automatic stay. 11 U.S.C. § 362(a)(7).⁶

The bankruptcy court discussed a holding of the Court of Appeals for the Sixth Circuit as to the three steps that are necessary for a setoff to occur: (1) the decision to exercise the right of setoff; (2) some action

⁵ *Id.* at 393. See 11 U.S.C. § 362(a)(7): “[A] petition filed under section 301, 302, or 303 of this title . . . operates as a stay . . . of—the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor. . . .”

⁶ 127 Bankr. at 393.

that accomplishes the setoff; and (3) a record that evidences that the right of setoff has been exercised.⁷ "Therefore, in this Circuit an administrative hold alone does not constitute a setoff and is not prohibited by section 362(a)(7)."⁸

The Jurisdictions Are Split

Notwithstanding its own circuit's definition of a setoff, the bankruptcy court indicated that there is substantial dispute among the courts as to whether an administrative freeze violates the automatic stay. Adding to the controversial cases, the court also noted that the issue has been the subject of much discussion in commentaries and scholarly journals.⁹ One commentator stated, "[I]t should be clear that a simple administrative hold by a bank creditor pending a resolution of a request for relief under § 362(d) will not violate the automatic stay."¹⁰ Following the enumeration of authorities, the court noted "with some embarrassment" that in the past it has been persuaded by arguments on both sides of this issue and has rendered conflicting opinions.¹¹

⁷ *Id.*, quoting from *Baker v. National City Bank of Cleveland*, 511 F.2d 1016, 1018. (6th Cir. 1975).

⁸ *Id.*, citing *In re Homan*, 116 Bankr. 595, 602 (Bankr. S.D. Ohio 1990).

⁹ *Id.*, citing, inter alia, Weintraub & Resnick, "Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code," 100 *Banking L.J.* 316 (1983) (hereinafter Weintraub & Resnick).

¹⁰ *Id.* 2 L. King, *Collier on Bankruptcy* ¶ 362.04[7] (15th ed. 1990).

¹¹ 127 Bankr. at 393-394.

Analyzing the holdings of the courts on each side of the issue, the bankruptcy court explained:

Those courts which find that an administrative hold does not violate the automatic stay emphasize that such action is not specified in section 362(a) and that banks must be able to protect their rights of setoff which are preserved by section 553 and 542(b). Courts reaching the opposite conclusion emphasize the importance and broad scope of the automatic stay, especially section 362(a)(3), and the fact that, at least from the debtor's standpoint, an extended administrative hold is tantamount to a completed setoff. Upon review, this Court finds the latter to be the more persuasive argument.¹²

The court was particularly impressed with the decision of Judge Waldron in *In re Homan*,¹³ which concluded that an administrative hold did not violate Section 362(a)(7), but held that such action violated Section 362(a)(3), which stays "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."¹⁴ The court noted that "the freeze is essentially an extra-judicial temporary restraining order. . . ."¹⁵

The bankruptcy court adopted Judge Waldron's conclusion that a

¹² *Id.* at 394.

¹³ 116 Bankr. 595 (Bankr. S.D. Ohio 1990).

¹⁴ 127 Bankr. at 394.

¹⁵ *Id.* at 394, quoting from *In re Wildcat Constr. Co.*, 57 Bankr. 981 (Bankr. D. Vt. 1986).

creditor could not resort to self-help to preserve a claimed interest in the debtor's deposit account but that the required course of action was for the creditor to initiate a proceeding to obtain relief from the automatic stay. This type of self-help could create "significant economic havoc for a debtor who is attempting to reorganize in order to obtain the relief contemplated by Chapters 11 or 12 and could have an even more and disastrous result upon an individual debtor's efforts to obtain the relief contemplated by Chapter 13."¹⁶

The court then considered the debtor's restraints as to the use of cash collateral. The court observed that pursuant to Sections 363(a) and 363(c)(2), funds on deposit and subject to a right of setoff constituted cash collateral that the debtor may not use without the Bank's consent or court authorization. The Bank argued that it was acting in accordance with this section restricting the debtor's use of cash collateral by placing an administrative hold on the debtor's accounts.

The court was not persuaded, however, "that because a bank may be acting in conformity with one policy of the Bankruptcy Code, its actions are exempt from other provisions of the Code."¹⁷ Additionally, an administrative hold was generally absolute in applying to the entire account balance in each of

the debtor's accounts whereas, the bank's security interest in those accounts was limited to the extent of its right to setoff provided in Sections 363(a), 506(a), and 553.¹⁸ "In the event that the Bank's right of setoff is less than the balance of the deposit account, a bank which unilaterally freezes the debtor's account reaches far beyond its rights in the cash collateral of the debtor." The court indicated that situations of this nature would be "more egregious than in the present case and clearly" a violation of the automatic stay.¹⁹

The court then found that the administrative hold placed on the DIP's account by the Bank was a violation of the automatic stay under Section 362(a)(3). Since there was no assertion that the Bank had actual knowledge of the bankruptcy filing or that it acted willfully, the court would not consider the issue of sanctions.²⁰

A Practical Solution

The court, however, recognized the practical problems that its holding will present to banks and suggested a procedure that financial institutions could utilize to overcome the hazard of violating the automatic stay. The court compared this procedure to one commonly utilized by debtors-in-possession:

Just as debtors-in-possession often come before the court on an expedited or emergency basis for a determi-

¹⁶ *Id.* at 394, quoting from *In re Homan*, 116 Bankr. at 603.

¹⁷ *Id.* at 395.

¹⁸ See 11 U.S.C. §§ 363(a), 506(a), 553.

¹⁹ 127 Bankr. at 395.

²⁰ See 11 U.S.C. § 362(h).

nation regarding the use of cash collateral, there are also provisions in the Bankruptcy Code and Rules for the expeditious consideration of a motion for relief from stay. Bankruptcy Rule 4001(a)(3) provides for *ex parte* relief from stay where immediate and irreparable injury, loss, or damage will result.²¹

Although the court considered its conclusion with respect to the automatic stay significant in that it would have an impact on future cases, it commented that its practical effect in the present case was minimal because of the second issue as to the extent of the Bank's right of setoff in the deposit accounts under Section 553 and the prohibition of the debtor's use of "cash collateral" by Sections 363(a) and 363(c)(2). The deposit accounts in question were cash collateral because of the Bank's secured claim to the extent of its right of setoff pursuant to Section 506(a).

The court was not persuaded by the DIP's argument that there was no right of setoff under Section 553 to the extent that the entire amount of DIP's obligations was not due at the time the petition was filed. The Bank's obligations were in default and subject to acceleration at the time of filing. "Furthermore, §-553 contemplates a 'netting' process where the aggregate claims of the parties are netted against one another."²²

The court also rejected the DIP's argument that pursuant to Ohio law, the Bank had no right of setoff with respect to the payroll account, which was a special deposit account. The court treated this argument as irrelevant since the bankruptcy estate acquired an interest in both deposit accounts at the time the petition was filed. At that time, the vast majority of the funds in question was in the general account and became cash collateral at that moment. The current balance in the payroll account actually included the DIP's postpetition transfer of funds from its general account that was subject to the right of setoff. This transfer constituted a use of cash collateral without the Bank's consent or court authorization. Thus, with the exception of a small sum in the payroll account, the remainder constituted cash collateral subject to the Bank's right of setoff.

The court treated the DIP's motion as one to use cash collateral. It also considered the agreement of the parties reflected in the court's prior order as consent of the Bank to use cash collateral. Alternatively, the court viewed the granting of a replacement lien as adequate protection of the Bank's interest as required by Section 363(e). The court's prior order was continued in effect unless the parties notified the clerk of the court that a final hearing on the use of cash collateral was required.

The court did not conclude its opinion without criticizing the DIP.

²¹ 127 Bankr. at 395.

²² *Id.* at 396.

The funds transferred to the payroll account one day after the petition was filed apparently were to be used to pay prepetition wages. Such payment by a DIP outside a confirmed plan of reorganization is generally prohibited by the Bankruptcy Code and such transfers are recoverable. The court did recognize that a "general practice has developed, however, where bankruptcy courts permit the payment of certain prepetition claims, pursuant to 11 U.S.C. § 105, where the debtor will be unable to reorganize without such payment."²³ The court also stated that it often permitted the payment of prepetition wages so as to allow a DIP to maintain an effective workforce, but "in no event may such payments be made *without prior authorization from the bankruptcy court.*"²⁴

Conclusion

As we read *In re Quality Interiors, Inc.*, a feeling of nostalgia takes us back some eight years to our article²⁵ in which we analyzed *In re Kenney's Franchise*:²⁶ "[O]ne of the first decisions regarding a bank's right to freeze a debtor's

account."²⁷ *Kenney's Franchise* had a factual pattern similar to the one in *Quality Interiors*. There was a loan agreement between the bank and its depositor under which there was a balance due the bank of \$63,000, secured by equipment valued at \$25,000. There was also a checking account with a balance of \$12,000. Upon the filing of the petition, the bank froze the account. The debtor's trustee filed a complaint seeking recovery of the \$12,000. The bank's answer and counterclaim alleged a banker's lien upon the account and that it was entitled to adequate protection pursuant to Section 362(d)²⁸ before the debtor could have use of the funds. Moreover, the property was "cash collateral," and therefore the debtor had no right to use it without first obtaining a court order pursuant to Section 363(c)(2).

The bankruptcy court in *Kenney's Franchise* rejected the bank's argument that the freeze did not constitute the exercise of a setoff because the balance of the account was not applied to the debt. The bank's failure to honor checks issued on the account was sufficient to constitute the exercise of the right of setoff in violation of the stay.

We criticized the holding in *Kenney's Franchise* because its analysis of the issue was seriously flawed. We commented that the Bankruptcy Code is a complex web often requir-

²³ *Id.*, citing *In re Chateaugay Corp.*, 80 Bankr. 279 (S.D.N.Y. 1987); *In re Structurite Plastics Corp.*, 86 Bankr. 922 (Bankr. S.D. Ohio 1988). See also 11 U.S.C. § 105.

²⁴ *Id.* at 396. See 11 U.S.C. § 549.

²⁵ See Weintraub & Resnick, note 9 *supra*.

²⁶ See *In re Kenney's Franchise* 12 Bankr. 390 (W.D. Va. 1981), *aff'd*, Civ. No. 81-0259 (W.Va. Mar. 24, 1982), *rev'd on reargument*, 22 Bankr. 747 (W.D. Va. 1982).

²⁷ See Weintraub & Resnick, note 9 *supra*, at 319.

²⁸ See 11 U.S.C. § 362(d).

ing the conciliation of numerous sections to arrive at a determination of rights. The bankruptcy court in *Kenney's Franchise* considered only Section 553(a), recognizing the right of setoff by a creditor, and Section 362(a)(7) applying the automatic stay to setoffs. However, the court failed to recognize setoffs as secured claims under Section 506(a) and the deposited funds as constituting cash collateral under Section 363(c)(2).

When, however, setoff rights are viewed as secured claims under section 506(a) and the deposited funds are treated as cash collateral pursuant to Section 363(c)(2), the right of the trustee or debtor to have use of the bank account balance without judicial approval is no greater than the bank's right to withhold the funds. Thus, a temporary freeze should be permissible pending a subsequent determination of the bank's protection upon the debtor's request for use of the funds. . . .²⁹

The court in *Quality Interiors* said that "[t]he issues presented in this case are relatively simple; however, the resolution of these issues, like

so many others faced by this court, is complicated by competing policies of the Bankruptcy Code."³⁰ We see no competing policy if the bank is permitted to maintain the status quo with a temporary administrative hold until the DIP assumes the initiative to obtain court approval for the use of cash collateral. Failing to act, the Bank should not be in violation of the automatic stay because of the "freeze" or "administrative hold."

We also find an informative analysis supporting our view that all the applicable sections of the Bankruptcy Code, not only Section 362, must be considered when determining whether an administrative hold by a bank of a debtor's deposit account constitutes a violation of the automatic stay. We refer to Mr. Justice Scalia's analysis of the concept of "an interest in property" under several sections of the Bankruptcy Code in the *Timbers* case: "Statutory construction, however, is a holistic endeavor. A provision that seems ambiguous in isolation is often clarified by the remainder of the statutory scheme. . . ."³¹

³⁰ 127 Bankr. at 392.

³¹ See *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 108 S. Ct. 626 (1988).

²⁹ See Weintraub & Resnick, note 9 *supra*, at 324.