

THE ADMINISTRATIVE FREEZE AND THE AUTOMATIC STAY: A NEW PERSPECTIVE

I. INTRODUCTION

A bank generally has a right to set off the amount of a customer loan against the amount in the customer's bank accounts. Several conflicting provisions in the Bankruptcy Code (Code), however, put a bank in a quandary when a customer files for bankruptcy. The bank's right of setoff is recognized by the Code as a secured claim,¹ but the Code does not make clear whether the bank may place an administrative hold or freeze² on the account in order to protect its setoff right.³ The ability to place an administrative freeze on the account is important for a bank because the bank will wish to prevent the customer's account from being dissipated while the exercise of the bank's setoff right is stayed by the Code.⁴ Thus, a bank must know whether its action in freezing the debtor's account violates the Code's automatic stay provision, section 362.⁵

The application of section 362 to a bank's imposition of an administrative freeze yields anything but a clear result and has engendered debate among both courts and commentators.⁶ This debate has had a narrow focus: May a bank place an administrative freeze on a debtor's account without violating section 362, the automatic stay provision? Both those who find that the freeze violates the automatic stay and those who find that it does not, have pointed to specific language in the Code supporting their position.⁷ This is not surprising because the relevant Code sections are in

1. 11 U.S.C. § 506 (1988).

2. A "freeze" is an administrative hold on an account whereby the account is not debited. James H. Wynn, *Freeze and Recoupment: Methods for Circumventing the Automatic Stay?*, 5 BANKR. DEV. J. 85 n.1 (1987). "The debtor is merely prevented from utilization of the funds in the account." *Id.*

3. The courts are divided on whether the "freeze" constitutes a violation of the automatic stay provision. *See, e.g., In re Wildcat Constr. Co.*, 57 B.R. 981 (Bankr. D. Vt. 1986); *Williams v. American Bank of Mid-Cities, N.A. (In re Williams)*, 61 B.R. 576 (Bankr. N.D. Tex. 1986). Several articles have also been written on the issue. *See, e.g., Benjamin Weintraub & Alan N. Resnick, Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code*, 100 BANKING L.J. 316 (1983); Wynn, *supra* note 2.

4. *See* Wynn, *supra* note 2, at 86-87.

5. 11 U.S.C. § 362 (1988).

6. *See supra* note 3.

7. *Compare Crispell v. Landmark Bank (In re Crispell)*, 73 B.R. 375, 379 (Bankr. E.D. Mo. 1987) (positing that "freeze" is implied by a reading of sections 362(a)(7), 542(b), and 553) (quoting

conflict.⁸ In addition to those weighing in on one side of the debate or the other, a recent decision, *In re Patterson*,⁹ has presented banks with an alternative to the administrative freeze. Unfortunately, each of these approaches suffers from the same flaw—failure to balance the competing policies presented in light of the nature of the proceeding.

The conflicting sections of the Code regarding the administrative freeze and automatic stay issue illustrate the need to redraft the language of the Code. Until the Code is redrafted, courts should look to the purpose of the Code as a whole and review individual Code provisions within a specific contextual framework. Upon doing so, courts would find that the rationale for allowing or disallowing a freeze depends upon the nature of the proceeding before the court.¹⁰ The proper analysis of an administrative

Stann v. Mid American Credit Union, 39 B.R. 246, 248 (D. Kan. 1984)) with *In re Quality Interiors*, 127 B.R. 391, 395 (Bankr. N.D. Ohio 1991) (noting that because a bank's setoff interest in deposit accounts is limited by sections 363(a), 506(a) and 553, a bank which unilaterally freezes a debtor's account reaches beyond its rights in the Code).

8. The relevant sections are: the automatic stay of section 362; the bank's right to setoff in section 553; the right to setoff as a secured claim in section 506; the cash collateral provision of section 363; and the turnover provisions of section 542. See Jack F. Williams, *Application of the Cash Collateral Paradigm to the Preservation of the Right to Setoff in Bankruptcy*, 7 BANKR. DEV. J. 27, 54 (1990).

For example, one of the conflicts is between 11 U.S.C. § 362(a)(3) which states "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" upon the filing of a bankruptcy petition and 11 U.S.C. § 542(a) which provides that "an entity . . . shall deliver to the trustee, and account for, such property [of the estate] or the value of such property. . . ." If an administrative freeze violates section 362(a)(3) as an act to exercise control over property of the estate, then the bank must honor checks drawn on the debtor's account. However, to the extent that such funds are cash collateral, they are property of the estate which cannot be used except by permission of the court or by consent of the bank. Therefore to turn over the funds would be to violate section 542. The bank is put in a no-win situation for which the Code provides no guidance. The situation illustrates the need to look not at the specific language of the Code sections but to overall Code policy within a specific context in order to reach a solution. See *infra* part V.

9. *In re Patterson*, 967 F.2d 505 (11th Cir. 1992).

10. For example, there are differing rationales for a setoff in a Chapter 7 liquidation as opposed to a Chapter 11 reorganization. See *infra* part V.

This Note treats the Chapter 13 "adjustment of debts" proceeding as equivalent to a Chapter 11 proceeding. This treatment is justified because proprietors of small businesses may file under Chapter 13. See WILLIAM R. MAPOTHER, CREDITORS AND THE NEW BANKRUPTCY CODE 191 (3rd ed. 1981). Moreover, because consumers can successfully reorganize under Chapter 13, small business proprietors may also be hurt in a Chapter 13 setting through use of the freeze. See *Georgia Federal Bank, FSB v. Owens-Peterson (In re Owens-Peterson)*, 39 B.R. 186, 190 (Bankr. N.D. Ga. 1984). Therefore, the same rationale applies. Similarly, because Chapter 9 incorporates many of the provisions of a Chapter 11 reorganization, the Chapter 11 analysis would also apply to a Chapter 9 proceeding. See Ronald M. Martin, *Creditor Alternatives To Obtain Relief From Automatic Stays In Bankruptcy*, 98 BANKING L.J. 525, 527 (1981).

freeze problem must tie the right to freeze to the basis for a setoff in the circumstances of the case before the court. Broad pronouncements by courts that the administrative freeze violates the automatic stay¹¹ are misguided.

Part II of this Note analyzes the relevant sections of the Code and describes the competing arguments for application of these sections to the administrative freeze problem. Part III discusses the cases interpreting the freeze. Part IV examines the recent case of *In re Patterson*¹² which provided banks with an alternative to using the administrative freeze. Finally, Part V criticizes the *Patterson* decision and sets forth a new approach that more appropriately addresses the competing policies confronting courts faced with an administrative freeze issue.

II. DISCUSSION OF THE BANKRUPTCY CODE

A. *The Automatic Stay*

The heart of the current controversy is whether the administrative freeze violates the Bankruptcy Code's automatic stay provision, section 362.¹³ The automatic stay is a fundamental debtor protection device, which is designed to provide the debtor with a repose from debt and a financial fresh start.¹⁴ However, the stay also serves creditors' interests by providing for the orderly administration of the debtor's estate.¹⁵ By

11. See, e.g., *Kenney's Franchise Corp. v. Cent. Fidelity Bank (In re Kenney's Franchise Corp.)*, 12 B.R. 390 (Bankr. W.D. Va. 1981), *rev'd*, 22 B.R. 747 (W.D. Va. 1982).

12. 967 F.2d 505 (11th Cir. 1992).

13. 11 U.S.C. § 362 (1988). See, e.g., Weintraub & Resnick, *supra* note 3.

14. See S. REP. NO. 989, 95th Cong., 2d Sess. 54 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840 ("[T]he automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. . . . It permits the debtor . . . to be relieved of the financial pressures that drove him into bankruptcy."). See also Robert A. Johnson & Marilyn C. O'Leary, *Automatic Stay Provisions of the Bankruptcy Act of 1978*, 13 N.M. L. REV. 599, 602 (1983) ("[T]he automatic stay of proceedings assures the debtor a breathing space in which to take stock of assets and assess liabilities free from the pressure of anxious creditors.").

15. See, I DAVID G. EPSTEIN ET AL., BANKRUPTCY § 3.3, at 86 (1992) ("The automatic stay ensures that no creditor receives more than an equitable share of the bankrupt's estate.") (quoting *In re Guterl Special Steel Corp.*, 111 B.R. 107, 110 (W.D. Pa. 1990), *aff'd*, 916 F.2d 890 (3d Cir. 1990), *cert. denied*, 111 S. Ct. 1640 (1991)). See also Johnson & O'Leary, *supra* note 14, at 602. Johnson and O'Leary assert that:

The stay prevents piecemeal dismantling of the estate and guarantees creditors that no one in their same position will receive proportionately more return on an extension of credit than will they The purpose of the stay is not to alter substantive rights of creditors, but merely to stay the exercise of these rights.

preventing a "rush" to the debtor's assets, the stay ensures that each creditor will be treated fairly.¹⁶

The scope of the automatic stay provision, section 362, is extremely broad and the section applies to all entities opposing the debtor.¹⁷ The stay does not extinguish a creditor's claim or other rights but only delays enforcing them.¹⁸ Section 362 provides that specified actions are exempt

Id. The legislative history adopted a similar view:

The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.

H.R. REP. NO. 595, 95th Cong. 2d Sess. 340 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6296-97.

16. *See* *Rett White Motor Sales Co. v. Wells Fargo Bank*, 99 B.R. 12, 13 (Bankr. N.D. Cal. 1989) (quoting *Price & Pierce Int'l, Inc. v. Spicers Int'l Paper Sales, Inc.*, 50 B.R. 25 (Bankr. S.D.N.Y. 1985)). The court noted:

The primary purpose of an automatic stay subsequent to the filing of a bankruptcy petition is "to preserve what remains of the debtor's insolvent estate and to provide a systematic equitable liquidation procedure for all creditors secured and unsecured . . . thereby preventing a chaotic and uncontrolled scramble for the debtor's assets in a variety of uncoordinated proceedings in different courts."

Id.

17. *See* 2 WILLIAM M. COLLIER, COLLIER ON BANKRUPTCY ¶ 362.04, at 362-34 (Lawrence P. King, ed., 15th ed. 1991) ("The stay of section 362 is extremely broad in scope and, aside from the limited exceptions of subsection (b), should apply to almost any type of formal or informal action against the debtor or the property of the estate.").

The automatic stay applies to eight actions. 11 U.S.C. § 362(a) provides that:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970 (15 U.S.C. § 78eee(a)(3)), operates as a stay, applicable to all entities, of-

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate of a judgment obtained before the commencement of the case under this title;

(3) 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;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) 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; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

18. 1 EPSTEIN ET AL., *supra* note 15, § 3.3, at 86.

from the stay¹⁹ and that a creditor may obtain relief from the stay under certain circumstances.²⁰ The stay goes into effect immediately upon the filing of a petition and continues until the estate property is exempted, sold or otherwise disposed of by the estate.²¹

In applying the automatic stay, courts must keep in mind the dual purposes of alleviating pressure on the debtor and ensuring equality of

19. However, it must be noted that these exemptions are limited. 11 U.S.C. § 362(b). Further, the court may still enjoin these actions, but because the stay does not apply automatically, the debtor must move the court for action to be taken. *See, Johnson & O'Leary, supra* note 14, at 607-08. Johnson and O'Leary state:

[I]t should not be assumed that these kinds of acts always should proceed. Rather, . . . the court . . . can stay matters not automatically stayed. However, . . . these acts are not affected by the automatic stay, and thus without intervention by the court will proceed without regard to the bankruptcy.

Id.

20. 11 U.S.C. § 362(d) provides:

On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay-

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or

(2) with respect to a stay of an act against property under subsection (a) of this section, if-

(A) The debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

While the legislative history uses real property as an example to indicate when relief might be warranted, the language of the statute should be read as applying to all property which is encumbered by a creditor's interest. *In re Anchorage Boat Sales, Inc.*, 4 B.R. 635, 641 (Bankr. E.D.N.Y. 1980).

Subsection (d)(1) is largely a restatement of the law under the Bankruptcy Act (Act) and reflects the policy of the cases decided under the Act. *Id.* at 642. In cases decided under the Act, the relevant factors in determining whether relief should be granted were: whether continuation of the stay would result in an undue risk of material harm to the creditor; whether there was a reasonable possibility of reorganization or rehabilitation; whether the property was needed by the debtor for a rehabilitation; and whether there was equity in the property that might be realized for the benefit of the debtor or its creditors. *Id.*

Most frequently, cause is shown by a debtor's failure to afford adequate protection of a secured creditor's interest in its security. *In re Lilyerd*, 49 B.R. 109, 116 (Bankr. D. Minn. 1985). The debtor has the exclusive responsibility of proposing a method of adequate protection. *In re Tudor Motor Lodge Ass'n*, 102 B.R. 936, 954 (Bankr. D.N.J. 1989).

Subsection (d)(2) applies only to the stay under subsection (a) of an act against property. 2 COLLIER, *supra* note 17, ¶ 362.07, at 362-69. Section 362 should require relief from the stay if there is no reasonable likelihood of reorganization. *Id.*

21. *See* 1 W. HOMER DRAKE, JR., BANKRUPTCY PRACTICE FOR THE GENERAL PRACTITIONER § 9.02, at 9-20 (2d ed. 1992) ("Upon the filing of a bankruptcy petition . . . the automatic stay continues with respect to any act against property of the estate as long as such property maintains such a status."). *See generally* 1 EPSTEIN ET AL., *supra* note 15, § 3.23 (noting that the stay continues until the case is ended, a discharge is granted or denied, the property leaves the estate, or relief is granted).

treatment for creditors.²² The automatic stay is designed first to provide breathing room for the debtor.²³ To the extent that an administrative freeze disrupts the debtor's repose, it violates this policy and courts should not allow its use.²⁴ The creditor bank should not be able to deny the debtor or trustee use of deposited funds without obtaining a court order.²⁵

Under certain circumstances, however, the automatic stay's second purpose—to enforce the orderly administration of the estate—must be given more weight.²⁶ If a bank is not allowed to freeze the account, then funds which belong to the estate, subject to the bank's right of setoff, may be dissipated.²⁷ Because the freeze helps to maintain the "status quo" as it existed prior to the filing of the petition, it furthers section 362's policy of orderly administration.²⁸ This argument favors use of the freeze.²⁹ Thus, the dual policies of the Code's automatic stay provision often conflict. Therefore, one must look elsewhere for a solution.

B. Setoff Under the Code—Section 553

A solution to this problem may be found in section 553 which clearly establishes that a bank's right to setoff³⁰ is preserved by the Code.³¹

22. See 2 DANIEL R. COWANS, COWANS BANKRUPTCY LAW AND PRACTICE § 11.3, at 301 (1989 ed.). Cowans observes:

The purposes of the stay have been described as to protect the debtor and creditors by allowing the debtor to organize his affairs and to insure that the bankruptcy procedure operates to allow an orderly resolution of all claims The stay is for the benefit of the creditors as well as the debtor

Id.

23. See *supra* note 14.

24. In particular, the freeze violates the concept of repose in reorganization cases because the debtor needs the cash collateral to meet operating expenses.

25. See Weintraub & Resnick, *supra* note 3, at 321.

26. See *supra* note 16.

27. While the bank can make a request for lifting the stay, the motion need not be ruled on for thirty days. See Barkley Clark, *Bank Exercise of Setoff: Avoiding the Pitfalls*, 98 BANKING L.J. 196, 224-26 (1981).

28. See *supra* note 16; Johnson & O'Leary, *supra* note 14, at 602 (stating that the stay assures creditors equality of returns on extensions of credit).

29. One author, however, has argued that the freeze disrupts the orderly administration of the estate and should be considered a violation of the automatic stay. See RICHARD I. AARON, BANKRUPTCY LAW FUNDAMENTALS § 5.01 (1992). The administrative freeze is justified only in instances in which the bank is seeking to protect its access to claimed cash collateral. The Code discourages this kind of self-help and unilateral action. *Id.* Further, Congress seemed to adopt this view when it amended section 362(a)(3) to add an exercise of control over property of the estate as a stayed action. *Id.*

30. See generally Alan M. Ahart, *Bank Setoff Under the Bankruptcy Reform Act of 1978*, 53 AM. BANKR. L.J. 205 (1979). Setoff is the right which exists between parties to net their debts where each

Because a deposit in a bank creates a debtor-creditor relationship between the bank and the depositor,³² a bank may set its obligation off against any debts which the debtor owes to it.³³ Banks attempt to justify the administrative freeze as a way to protect their right to setoff.³⁴ Therefore, whether the bank retains a right to setoff under the Bankruptcy Code is of critical importance.³⁵

The right to setoff existing under state law is retained by the current Code under section 553.³⁶ To establish a right to setoff, a creditor must show a prepetition debt owed by the creditor to the debtor,³⁷ a prepetition

party owes the other an ascertained amount. *Id.* In an action for the larger debt, only the balance is recoverable. *IML Freight, Inc. v. United States (In re IML Freight, Inc.)*, 65 B.R. 788 (Bankr. D. Utah 1986).

31. 11 U.S.C. § 553(a) provides, *inter alia*, that:

[T]his 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.

...

Therefore, the Bankruptcy Code does not create or define, but rather, recognizes and preserves the common-law right of setoff under nonbankruptcy law. The Code is not an independent source of the right to setoff and the creditor must establish a right to setoff by applying the law of the state where the facts occurred. *See Moses v. United States Dep't of Educ. (In re Moses)*, 91 B.R. 994, 996 (Bankr. M.D. Fla. 1988); *In re McLean Indus., Inc.*, 90 B.R. 614, 618 (Bankr. S.D.N.Y. 1988); *Kittrell v. State Employees Credit Union (In re Kittrell)*, 115 B.R. 873, 881 (Bankr. M.D.N.C. 1990). The right to setoff is recognized to prevent the possible injustice of compelling a creditor to pay his indebtedness to the debtor in full when his claim may only be partially paid, if at all. *Morristown Lincoln-Mercury v. Hamilton Bank of Morristown (In re Morristown Lincoln-Mercury, Inc.)*, 42 B.R. 413, 416 (Bankr. E.D. Tenn. 1984). Without recognition of the right to setoff, an attempt to set off would amount to a preference under section 547 and would be invalid. *In re Moses*, 91 B.R. at 996.

32. *See Clark, supra* note 27, at 196.

33. *See* 4 COLLIER, *supra* note 17, ¶ 553.15, at 553-67.

34. *See* Kathleen Thorne, Note, *Automatic Stay: Section 362*, 3 BANKR. DEV. J. 181, 187 (1986) ("[T]he majority trend is to view the administrative freeze as an appropriate way for the bank to 'maintain the status quo' until the rights of the parties can be determined by a bankruptcy court.") (footnotes omitted).

35. The right to setoff should be distinguished from recoupment. Recoupment requires that the mutual demands must arise from the same transaction on which the plaintiff has sued. Setoff is stayed by section 362; recoupment is not. Therefore, recoupment allows a creditor to assert that certain mutual claims extinguish one another when setoff would not be allowed without prior judicial approval. This treatment results because it is considered inequitable to apply the limitation on setoff to the right of recoupment. *See, Wynn, supra* note 2, at 102-06; *Holford v. Powers (In re Holford)*, 896 F.2d 176, 179 (5th Cir. 1990) (holding that recoupment is not stayed and the trustee takes property subject to recoupment rights). *But see Ohning v. Schneider Nat'l Transcontinental, Inc. (In re Ohning)*, 57 B.R. 714, 717 (Bankr. N.D. Ind. 1986) (holding that use of recoupment was an intentional violation of the automatic stay.).

36. *See supra* note 31.

37. A "debt" is a liability on a claim. 11 U.S.C. §§ 101(4), 101(11) (1988).

claim of the creditor against the debtor,³⁸ and that the debt and the claim are mutual obligations.³⁹ The mutual debts must arise before the commencement of the case and the setoff must be valid under state law.⁴⁰ Courts generally hold that for claims to be mutual under the Code, the debts must subsist between the same parties in the same right or capacity and be of the same kind or quality.⁴¹ If the creditor is able to satisfy these requirements, then the creditor may "obtain full satisfaction of its claim by extinguishing an equal amount of the creditor's obligation to the debtor."⁴² The allowance of setoff is not automatic but is at the discretion of the bankruptcy court, applying general principles of equity.⁴³

There are limits, however, on the bank's use of a setoff as a solution to the administrative freeze and automatic stay problem.⁴⁴ First, the automatic stay provision applies to a setoff, and requires creditors to obtain

38. A "claim" is broadly defined under the Code as "a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . ." 11 U.S.C. § 101(4) (1988).

39. *In re Lundell Farms*, 86 B.R. 582 (Bankr. W.D. Wisc. 1988); *Morristown Lincoln-Mercury v. Hamilton Bank of Morristown (In re Morristown Lincoln-Mercury, Inc.)*, 42 B.R. 413, 416 (Bankr. E.D. Tenn. 1984).

40. *Hecht v. Chemical Bank (In re Hecht)*, 41 B.R. 701, 703 (Bankr. S.D.N.Y. 1984) ("Section 553(a) allows a creditor to set off a mutual debt owed by the creditor to the debtor against a claim of the creditor against the debtor, so long as these mutual debts arose before the commencement of the case, and so long as the setoff is valid under state law."); *In re Academy Answering Servs., Inc.*, 90 B.R. 294, 296 (Bankr. N.D. Ohio 1988) (holding that a creditor must establish a right to setoff the debts under nonbankruptcy law); 4 COLLIER, *supra* note 17, ¶ 553.08, at 553-45 (stating that to be eligible for setoff both the mutual claim of the creditor and debt of the debtor must have arisen prior to the commencement of the case).

41. *In re Braniff Airways, Inc.*, 42 B.R. 443, 449 (Bankr. N.D. Tex. 1984) ("Mutuality of obligation simply means that the creditor is indebted to the debtor who likewise owes a debt to the creditor; something must be owed by both sides."). *In re Morristown Lincoln-Mercury, Inc.*, 42 B.R. at 416. *Accord Art Metal U.S.A., Inc. v. United States General Servs. Admin. (In re Art Metal U.S.A., Inc.)*, 109 B.R. 74, 78 (Bankr. D.N.J. 1989).

42. *In re Braniff Airways, Inc.*, 42 B.R. at 448. This ability is criticized as conflicting with the fundamental policy of distribution because, in effect, the creditor receives a preference. *Id.* However, if a setoff is denied, then the creditor pays into the estate the full amount which it owed while receiving only a pro rata distribution made to all unsecured creditors. *Id.* The Code avoids this result and retains the long history of permitting setoff in bankruptcy. *In re Academy Answering Services*, 90 B.R. at 296.

43. *In re Pieri*, 86 B.R. 208, 210 (Bankr. 9th Cir. 1988) (stating that setoff should not be allowed when it would be inequitable or contrary to public policy).

44. Banks are usually the primary beneficiaries of the right of setoff because deposits are treated as creating debts owed by the bank to its customer which may be set off against the customer's loan obligation. *Weintraub & Resnick, supra* note 3, at 317. These limitations reflect a congressional purpose to restrict the right of setoff and to treat it as a preference in certain circumstances. *See* 4 COLLIER, *supra* note 17, ¶553.01, at 553-6.

court permission before taking any action against the property of the estate.⁴⁵ Second, section 553(b) restricts the right of setoff under state law and treats the exercise of a setoff as a preference under certain circumstances.⁴⁶ Congress intended to limit the amount a creditor can set off under state law, so that one creditor could not improve his position at the expense of unsecured creditors. Section 553(b) takes precedence over any state law to the contrary.⁴⁷ Finally, sections 553(a)(2) and 553(a)(3) seek to prohibit setoff where a deposit is accepted by a creditor with the intent of applying it to a pre-existing claim against the debtor.⁴⁸

C. *Right to Setoff As a Secured Claim—Section 506*

Some courts also believe section 506, the Code's secured claim provision, provides an answer to the administrative freeze and automatic stay problem. The Code treats a bank's right to setoff⁴⁹ as a secured

45. 11 U.S.C. § 362 (1982). However, the stay does not affect creditors' substantive rights. It simply stays enforcement pending an orderly examination of the debtor's and creditors' rights. See S. REP. NO. 989, 95th Cong., 2d Sess. 51 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5837.

46. *In re Hecht* 41 B.R. 701, 704 (Bankr. S.D.N.Y. 1984). The circumstances in which a setoff will be treated as an avoidable preference by the trustee are when the creditor improves his position based upon the setoff of a mutual debt within the ninety day period preceding the filing of the petition. *Id.* The trustee can recover the amount "by which the insufficiency on the date of setoff is less than the insufficiency would have been had the setoff occurred ninety days before the filing of the bankruptcy petition or on the first day after the ninetieth day on which there was an insufficiency." *Id.* See H.R. REP. NO. 595, 95th Cong., 2d Sess. 185 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 6145 ("The bill also adds the improvement in position test as a limitation. Under this test . . . any increase during the three months before bankruptcy in the amount of the debt owing by the creditor to the debtor would not be permitted to be offset."). This test was meant to prevent the exercise of the setoff right from becoming a precipitating event which pushes the debtor into bankruptcy. See AARON, *supra* note 29, § 10.06; H.R. REP. NO. 595, *supra*, at 186, reprinted in 1978 U.S.C.C.A.N. 5963, 6147 ("The result is to encourage business workouts, by discouraging precipitous action.").

47. See AARON, *supra* note 29, § 10.06, at 2-3.

48. Section 553(a)(2) prohibits a setoff of a creditor's claim against the debtor when the claim was acquired from a third party within 90 days before the petition while the debtor was insolvent. 11 U.S.C. § 553(a)(2). Section 553(a)(3) negates the setoff if the debts owed to the debtor from the creditor were incurred by the creditor for the purpose of obtaining a right of setoff within 90 days of filing the petition while the debtor was insolvent. 11 U.S.C. § 553(a)(3). Further, section 553(c) creates a presumption that the debtor was insolvent during the 90 day period prior to the filing of the petition. 11 U.S.C. § 553(c). *Accord* *Moses v. United States Dep't of Educ.* (*In re Moses*), 91 B.R. 994, 996-97 (Bankr. M.D. Fla. 1988); *Kittrell v. State Employees Credit Union* (*In re Kittrell*), 115 B.R. 873, 881 (Bankr. M.D.N.C. 1990) ("[T]he setoff exception of § 553(a) does not apply where a deposit is accepted or obtained by a credit union with the intent of applying it to a pre-existing claim against the depositor.").

49. Setoff is defined as "[T]he equitable right to cancel or offset mutual debts or cross demands, commonly used by a bank in reducing a customer's checking or other deposit account in satisfaction of a debt the customer owes the bank." BLACK'S LAW DICTIONARY 1372 (6th ed. 1990).

claim in section 506 to the extent of the amount subject to setoff.⁵⁰ The Code's treatment can be criticized because a major tenet of bankruptcy law is that all creditors are to receive equitable treatment.⁵¹ By providing for a setoff right, the Code, in effect, gives the bank, with an otherwise unsecured claim, a preference over other unsecured creditors.⁵² However, because the right to setoff has been so entrenched in the history of bankruptcy litigation, the drafters felt that it should be maintained.⁵³

Section 363 is closely related to section 506. Under section 363, the cash in the debtor's account which is subject to the right of setoff by the bank is "cash collateral."⁵⁴ Therefore, the money in the account may not be used unless each entity with an interest in the cash collateral consents, or unless the court, after notice and hearing, authorizes such use.⁵⁵

50. 11 U.S.C. § 506 provides:

(a) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that the value of . . . the amount so subject to setoff is less than the amount of such allowed claim.

See also *Gulfstream Bank, N.A. v. R.C.I. Enters., Inc.* (*In re R.C.I. Enters., Inc.*), 22 B.R. 549, 551 (Bankr. S.D. Fla. 1982). In effect, this equates a right of setoff with a lien because the bank holds a secured claim to the extent of the right to setoff. 2 COLLIER ON BANKRUPTCY ¶ 553.15, at 553-70 (15th ed. 1990).

51. See *supra* note 16.

52. The legislative history of 11 U.S.C. § 101(40) provides that a setoff is not to be set aside as a preferential transfer but is subject to special rules. *Sarkis v. American State Bank of Rapid City* (*In re Sarkis*), 17 B.R. 174, 176 (Bankr. D.S.D. 1982).

53. A claimant who properly invokes setoff elevates an unsecured claim to a secured position, thereby receiving a permissible preference over other creditors. However, the right of setoff is based upon long-recognized rights of mutual debtors and has been embodied in every bankruptcy law the United States has enacted. See *supra* note 49-52. The treatment is due, in part, to a belief that injustice would result from requiring a creditor to pay its indebtedness in full to the state and then to wait in line to obtain satisfaction of its claim. See *Big Bear Supermarket No. 3 v. Princess Banking Corp.* (*In re Princess Banking Corp.*), 5 B.R. 587, 589 (Bankr. S.D. Cal. 1980); *Niagara Mohawk Power Corp. v. Utica Floor Maintenance, Inc.* (*In re Utica Floor Maintenance, Inc.*), 41 B.R. 941, 943 (Bankr. D.D.C. 1984); *American Cent. Airlines, Inc. v. United States Dep't. of Transp.* (*In re American Cent. Airlines, Inc.*), 60 B.R. 587, 589-90 (Bankr. N.D. Iowa 1986).

54. 11 U.S.C. § 363(a) provides that: "In this section, 'cash collateral' means cash . . . in which the estate and an entity other than the estate have an interest. . . ." Commentators have noted that "a bank stayed from setting off under section 362(a)(7) would be treated as the holder of a secured claim under section 506(a) to the extent of the deposit account and the deposit account is considered 'cash collateral' under section 363(a)." 2 COLLIER, *supra* note 17, ¶ 363.02, at 363-416.

55. 11 U.S.C. § 363(c)(2). For a discussion of how a court should reach this decision, see Stephen A. Stripp, *Balancing Of Interests In Orders Authorizing the Use Of Cash Collateral In Chapter 11*, 21 SETON HALL L. REV. 562 (1991). The protection is offered in recognition of the risk to a creditor with an interest in the collateral from its consumption in a rehabilitative effort in bankruptcy. 2 COLLIER, *supra* note 17, ¶ 363.02, at 363-416. 1990).

Further, an entity with an interest in the cash collateral may request that the court condition such use to protect the interest of all creditors.⁵⁶ Because the bank has an interest in the cash collateral, it may request adequate protection for that interest.⁵⁷ Adequate protection is not specifically defined but illustrations of adequate protection are provided by section 361.⁵⁸

Banks argue that through section 506, in conjunction with section 363, Congress approved the use of the administrative freeze on a debtor's account.⁵⁹ Section 506, as discussed earlier, provides that a creditor with a right to setoff is a secured creditor up to the amount of setoff.⁶⁰ Furthermore, Section 363(c) operates so that the money in the debtor's account is treated as cash collateral and may not be used unless the bank consents or the court authorizes such use.⁶¹ Thus, banks argue that by

56. 11 U.S.C. § 363(e). Adequate protection encompasses protecting a secured creditor from suffering a decline in the value of the collateral during a bankruptcy proceeding. *Barclays Bank of New York, N.A. v. Saypol* (*In re Saypol*), 31 B.R. 796, 799-800 (Bankr. S.D.N.Y. 1983). See *In re Certified Corp.*, 51 B.R. 768, 771 (Bankr. D. Haw. 1985) ("This protection must result in the indubitable equivalent of a secured creditor's interest in the property.") The trustee has the burden of proof on the issue of adequate protection at any hearing under section 363. 2 COLLIER, *supra* note 17, ¶ 363.07, at 363-431.

57. The interest in the collateral is a security interest and, as such, is a property right protected by the Fifth Amendment from public taking without just compensation. *Chrysler Credit Corp. v. George Ruggiere Chrysler-Plymouth* (*In re George Ruggiere Chrysler-Plymouth*), 727 F.2d 1017, 1019 (5th Cir. 1984). Constitutionally, the bankruptcy court cannot allow use of the cash collateral that would threaten the creditor's interest. *Id.* The Code resolves the issue by mandating that the court condition the use of the secured property (*i.e.*, the cash collateral) "as is necessary to provide adequate protection." *Id.*

58. 11 U.S.C. § 361. For a discussion of what constitutes lack of adequate protection, see Annotation, *What Constitutes Lack Of "Adequate Protection" Of Interest In Property Of Estate for Which Relief May Be Granted From Automatic Stay Provision Of Bankruptcy Code of 1978 (11 USCS § 362(a))*, 66 A.L.R. FED. 505 (1982). By adequate protection, Congress contemplated "that which 'will result in the realization by the [secured creditor] of the value of its interest in the property.'" *In re Saypol*, 31 B.R. at 801 (quoting H.R. REP. NO. 575, 95th Cong., 1st Sess. 340, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6296).

Most courts find adequate protection as long as the creditor's interests are preserved at "status quo," or can be protected from diminution. *In re Triplett*, 87 B.R. 25, 26 (Bankr. W.D. Tex. 1988). In a bank context, adequate protection is that which insures the bank of "payment of the portion of the debt that is on deposit with the bank." See H.R. REP. NO. 595, 95th Cong., 2d Sess. 185 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6146.

59. See, e.g., *Bank of America Nat'l Trust and Sav. Ass'n v. Edgins* (*In re Edgins*), 36 B.R. 480, 482-83 (Bankr. 9th Cir. 1984).

60. See *supra* note 50.

61. *Zeeway Corp. v. Rio Salado Bank* (*In re Zeeway Corp.*), 71 B.R. 210, 211 (Bankr. 9th Cir. 1987) ("The Court may allow the debtor to use cash collateral after notice and hearing and upon providing adequate protection for the creditor's interest."). *Id.* The debtor, on the other hand, must

placing a freeze on the debtor's account banks are merely satisfying the Code's policy and protecting their interest to prevent the deprivation of cash collateral.⁶²

Further, section 363(e) grants the bank, as a secured creditor, the right to petition for adequate protection as a condition to use of cash collateral.⁶³ The automatic stay will be lifted under section 362(d) upon motion by the bank unless adequate protection is provided.⁶⁴ If the bank cannot

propose some form of relief that will preserve the secured creditor's interest in the collateral and will effectively compensate the secured creditor for any loss of value. See *In re EES Lambert Assocs.*, 62 B.R. 328, 343 (Bankr. N.D. Ill. 1986).

Jack Williams proposes that section 363(c) provides the appropriate analysis for the administrative freeze problem. Williams, *supra* note 8, at 54. Mr. Williams states that this section dictates that a freeze should be allowed because it furthers the requirement that a debtor is to provide adequate protection for the creditor's interest in the cash collateral. *Id.* at 61. Mr. Williams' analysis is flawed.

First, as Mr. Williams recognizes, section 363(c) applies only in business reorganization situations. *Id.* at 60. But, he argues that the section should be broadly construed to provide creditors with adequate protection in Chapter 13 cases as well. *Id.* at 60-61. This analysis fails to consider that the creditor is not denied the right to adequate protection when a freeze is denied. The creditor can move for ex parte relief under either section 362(f) or 363(e) should it feel its interest is not protected. See 11 U.S.C. §§ 362(f), 363(e) (1988).

Second, Mr. Williams does not adequately rebut the objection that section 362(a)(3) prohibits any act to exercise control over the debtor's property. Mr. Williams merely states that a reading of the section which would prohibit the freeze would endanger many provisions in the Code which protect creditors. *Id.* at 62. This argument is unpersuasive because it fails to consider policy justifications for treating a specific act as violative of this section. Mr. Williams emphasizes the creditor's interests without considering the competing interests of the debtor.

In conclusion, Mr. Williams analysis is too slanted in favor of creditors' rights. Mr. Williams states that the debtor's avenue to alleviate harm caused by the administrative freeze is granted by section 363(c)(2): that the debtor must request use of the cash collateral from a court. *Id.* at 63. He bases this conclusion on the right of a creditor to adequate protection for its interest. *Id.*

This approach ignores the reality that in a reorganization, the debtor's need for the cash collateral is paramount. By refusing to credit the debtor's concern, Mr. Williams fails to consider that in certain situations it is appropriate to require the creditor to seek the methods provided by section 362(f) and 363(e) to protect its interest as opposed to requiring the debtor to seek relief.

The Williams Article strikes this author as treating the creditor as an unprotected victim. The creditor is not immune from attack for using the administrative freeze. The freeze embodies an extra-judicial determination of a right to setoff. This action outside the judicial framework is as open to attack as a debtor's use of cash collateral, arguably, in violation of section 363(c). Mr. Williams, however, does not discuss this aspect of the problem.

62. The policy is necessary because "[c]ash collateral is a unique form of collateral that requires special protection since it is most likely to be consumed during the reorganization process and is at times subject to change on an almost daily basis." *In re EES Lambert Assocs.*, 62 B.R. at 343.

63. 11 U.S.C. § 363(e) (1988).

64. "[U]se [of cash collateral] must be prohibited or conditioned as is necessary to provide adequate protection of the secured creditor's interest." *In re EES Lambert Assocs.*, 62 B.R. at 343. This concept is based upon the realities of a bankruptcy case. The use of cash collateral is essential to the success of a reorganization. However, this use diminishes the value of the security provided the

freeze the account, then the right to lift the automatic stay becomes meaningless because cash can be used without adequate protection.⁶⁵

Although the banks' arguments in favor of allowing an administrative freeze are powerful, they conflict with other Code policies. In a reorganization case for example, the debtor may need access to the cash collateral in order to meet current operating expenditures.⁶⁶ To allow the freeze would frustrate the debtor's interest in direct violation of the policies of the Code.⁶⁷ Further, section 363(c) only applies to the trustee.⁶⁸ While the bank would be furthering the overall policy of section 363 by placing an administrative freeze on the debtor's accounts, the explicit mandate of section 362 should outweigh this "good citizen" argument.⁶⁹ Finally, the argument in favor of the right to adequate protection can be countered just as the argument in favor of the right to setoff may be countered. The Code requires that the court determine the right to setoff.⁷⁰ Because it is only by a right to setoff that a bank has a right to adequate protection,⁷¹ it does no disservice to the underlying policies of the Code to deny the bank an uncontested right to freeze.

creditor, thus eroding its secured position. This dilemma was addressed by allowing a creditor whose cash collateral is to be used to request that the court condition the use upon provision of adequate protection. See *Worcester County Nat'l Bank v. Xinde Int'l, Inc.* (*In re Xinde Int'l, Inc.*), 13 B.R. 212 (Bankr. D. Mass. 1981).

65. This contention bolstered by statements of individual legislators concerning the use of cash collateral. See 124 CONG. REC. 32,396 (1978) (remarks of Rep. Don Edwards) ("The trustee or debtor in possession may use, sell, or lease cash collateral in the ordinary course of business only 'after notice and a hearing.'"); 124 CONG. REC. 32,419 (1978) (remarks of Rep. Caldwell Butler) ("The debtor in possession may use all collateral in the ordinary course of business without a hearing except for 'cash collateral' which requires the opportunity for a hearing except in emergencies.").

66. See Stripp, *supra* note 55, at 565-66.

67. The stay is meant to provide breathing room for the debtor and a denial of collateral in a reorganization would prevent this. See Thorne, *supra* note 34, at 188.

68. 11 U.S.C. § 363(c) (1988).

69. Section 362 provides that the automatic stay applies to "any act to obtain possession of property of the estate. . . ." 11 U.S.C. § 362(a)(3) (1988). This specific language and the overall policy of debtor repose in the stay would trump any argument focused on the furtherance of the section 363 policy.

70. Section 362 stays an exercise of setoff. 11 U.S.C. § 362(a)(7). Section 362(d) allows for relief from the stay if the court determines that the bank is not adequately protected. 11 U.S.C. § 362(d)(1). Any relief from the stay must be accomplished by a court order. 11 U.S.C. §§ 362, 363 (1988).

71. 11 U.S.C. § 363(a) (1988) ("In this section, 'cash collateral' means . . . deposit accounts . . . whenever acquired in which the estate *and an entity other than the estate* have an interest . . .") (emphasis added).

D. Turnover Provisions of the Code

Finally, section 542(c) may provide justification for the bank's use of a freeze. Under section 542(b), a bank with a right of setoff need not turn over property of the estate to the trustee.⁷² However, section 542(c) implicitly makes a creditor who has knowledge of the filing of the bankruptcy case liable for turning over property of the estate to an entity other than a trustee.⁷³

Because section 543(c) makes a bank which has knowledge of the bankruptcy petition accountable for estate property which it transfers,⁷⁴ some commentators argue that a bank must be allowed to freeze a debtor's account to prevent liability.⁷⁵ This contention is met by section 542(b) which does not require an entity with a right to setoff to turn over money payable to the debtor.⁷⁶ The bank, which has a right to setoff, would not be violating this section by allowing withdrawals from the debtor's account because the funds would not be subject to turnover.⁷⁷

Unfortunately, banks may not rely solely on section 542(c) to justify the use of the administrative freeze. Section 542 provides no independent justification for the bank's actions. Therefore, the bank must look

72. 11 U.S.C. § 542(b) (1988) provides:

Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

73. 11 U.S.C. § 542(c) (1988). Importantly, under this section, if the bank has knowledge of the filing, it will not be protected. The bank will be liable to the estate for the amount of money which is turned over.

74. *Id.* This section states that "an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate . . ." *Id.* The clear implication is that an entity with notice or knowledge may not transfer property and would be accountable to the trustee, under section 542(a), to turn over the property of the estate which it controls.

75. *See, e.g., Williams, supra* note 8, at 45 ("[O]ne implication of section 542(c) is that if the creditor transfers property of the estate after it receives notice of the filing it does so at its own peril. In order to protect itself from liability . . . the creditor has no alternative but to freeze the debtor's account.").

76. However, section 542(b) also provides support for use of the administrative freeze. The section requires any entity owing a debt to the debtor to pay such debt except to the extent that the debt is subject to setoff. 11 U.S.C. § 542(b). Thus, it could be argued that the Code recognizes a difference between the mere withholding of funds and the exercise of the setoff right. Therefore, an entity claiming a right of setoff may retain funds via an administrative freeze until its setoff right is determined. *See* 4 COLLIER, *supra* note 17, ¶ 553.15, at 553-584, 587.

77. 11 U.S.C. § 542(d) (1988). *See also* Weintraub & Resnick, *supra* note 3, at 323 (stating that turnover of funds subject to a setoff right would not violate § 542(b)).

elsewhere to justify its use of the freeze.

E. Conclusion

The discussion above illustrates that applying the conflicting provisions of the Code to an administrative freeze is a complex and difficult task. Unfortunately, both the language and policy of these sections provide no clear answer to the questions raised by a bank's use of the administrative freeze when read in isolation. Any argument in favor of one interpretation may be effectively attacked by reference to another section or policy. Therefore, the problem should be addressed through a functional approach, taking into account the differing contexts in which the freeze may be maintained. As will be shown in Part III, however, most courts have refused to take such an approach.

III. DISCUSSION OF CASES INTERPRETING THE ADMINISTRATIVE FREEZE

A. Cases Holding That the Freeze Violates the Stay

In *In re Wildcat Construction Co.*,⁷⁸ the bankruptcy court held that the freeze violated the stay.⁷⁹ The court noted that through use of a freeze, the bank would be making an extra-judicial determination concerning its secured status and the identification of the funds in the debtor's account as cash collateral.⁸⁰

The court also noted that section 362 in effect provides a "stalemate" which protects both parties and makes an administrative freeze unnecessary.⁸¹ The Code's automatic stay prohibits the bank from setting off. And, because the debtor must obtain the court's permission before using cash collateral,⁸² the Code also prohibits the debtor from using the funds. In other words, if the bank is correct about the funds, then the debtor may not use the cash collateral. However, if the bank is wrong, then it had no right to preclude access in the first place. In either scenario, the court found that the freeze was unnecessary.⁸³

78. 57 B.R. 981 (Bankr. D. Vt. 1986).

79. *Id.* at 984-87.

80. *Id.* at 986.

81. *Id.*

82. *Id.*

83. *Id.*

In *In re Kenney's Franchise Corp.*,⁸⁴ the court held that the freeze was a violation of both the spirit and purpose of the automatic stay provision.⁸⁵ The court determined that section 362's language is broad and encompassing in its prohibition.⁸⁶ Therefore, the freeze upsets the congressional policy of the orderly administration of bankruptcy cases.⁸⁷ The court emphasized that the freeze was a refusal to recognize the debtor's rights in the account and therefore violated the bank's duty to honor the debtor's requests.⁸⁸ The administrative freeze contravened the automatic stay policies of orderly administration and debtor repose.⁸⁹

In *In re Quality Interiors, Inc.*,⁹⁰ the court also found that the freeze violated the stay.⁹¹ First, the court agreed with the discussion of the automatic stay and administrative freeze issue in *In re Homan*.⁹² The *Homan* court concluded that the creditor-bank cannot assert an interest in the funds on deposit and resort to self-help to preserve that claimed interest, because the Code demands that the creditor initiate a filing to obtain relief from the stay.⁹³ The *Homan* court noted that the freeze creates significant economic havoc for a debtor attempting to reorganize under Chapter 11 or 12 and causes even more disastrous consequences for an individual attempting to obtain relief under Chapter 13.⁹⁴

Second, the *Quality Interiors* court concurred with *Homan's* dismissal of the argument that a bank is merely acting in accordance with the Code by preventing the debtor in possession's use of cash collateral through use of the freeze.⁹⁵ The *Homan* court ruled that the argument could be persuasive in a Chapter 11 filing but is not equally applicable to Chapter 13 cases.⁹⁶ While the *Homan* case was a Chapter 11 case, the court refused

84. 12 B.R. 390 (Bankr. W.D. Va. 1981), *rev'd*, *Kenney's Franchise Corp. v. Cent. Fid. Bank*, 22 B.R. 747 (Bankr. W.D. Va. 1982).

85. *Id.* at 394.

86. *Id.* at 391-92.

87. *Id.* at 394.

88. *Id.*

89. *Id.*

90. 127 B.R. 391 (Bankr. N.D. Ohio 1991).

91. *Id.* at 395.

92. 116 B.R. 595 (Bankr. S.D. Ohio 1990)

93. *Id.* at 603.

94. *Id.*

95. 127 B.R. at 394-95.

96. "[W]hile such an argument could be persuasive in a Chapter 11 proceeding, this argument . . . is not equally applicable to the vast majority of Chapter 13 cases, which are consumer, not business, filings." *Id.* at 395 (quoting *In re Homan*, 116 B.R. at 604).

to recognize that a bank is exempt from conformity with other provisions of the Code simply because it is acting in conformity with one policy of the Code.⁹⁷

Third, the *Quality Interiors* court noted that the freeze is absolute, applying to the entire account.⁹⁸ However, the bank's security interest in the account extended only as far as its right to setoff.⁹⁹ Therefore, the freeze violated the broad principles of the automatic stay provision.¹⁰⁰

The court concluded by observing that the case did not present a situation which required a financial institution to seek self-help.¹⁰¹ The court referred to Bankruptcy Rule 4001(a)(3) which provides for ex parte relief from the stay where immediate and irreparable injury, loss, or damage will result.¹⁰² While the filing procedure could be burdensome on the financial institution, it ensures a judicial determination of the rights of the parties and is consistent with the language of the automatic stay.¹⁰³

In *In re Rio*,¹⁰⁴ the court held that an administrative freeze upsets the

97. 116 B.R. at 395. This ruling of the *Quality Interiors* court is open to debate. While the court correctly concluded that the provisions are in conflict, it implicitly held that the stay policy was more important than the cash collateral provision. Given the importance of the stay provision, this may be defensible. However, the court provided no rationale for its holding. It could very well be that compliance with the cash collateral provision should exempt the bank from compliance with other policies. The court's holding was conclusory and gave short treatment to the competing arguments.

98. 127 B.R. at 395.

99. *Id.*

100. *Id.* The court observed:

In the event that the bank's right to 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. In this situation, the bank's exercise of control over property of the estate would be . . . clearly within the scope of actions prohibited by the automatic stay. This is an example of the type of "self-help" . . . which the *Homan* . . . court[] sought to avoid.

Id.

101. *Id.* ("[T]his court, like Judge Waldron [writer of the opinion in *Homan*], 'is not persuaded that the Code sections under discussion place a financial institution in a situation from which it cannot escape without resort to self-help.'" (quoting *In re Homan*, 116 B.R. at 605).

102. *Id.*

103. *Id.* This case reflects the problems which can occur with individual, extra-judicial determination concerning rights to funds. The debtor had transferred money from a general account to a payroll account. *Id.* at 392. This constituted an unauthorized use of cash collateral in violation of section 363 and rendered irrelevant the debtor's argument that, under Ohio law, the creditor had no right to setoff in the payroll account. *Id.* at 392-93. The court took the debtor's motion for a release of the administrative hold on the payroll account as a motion for use of cash collateral and found that the creditor had previously consented to such use. *Id.* at 395. The complexity of the arguments demonstrates the inadequacy of personal determinations concerning rights such as use of the freeze.

104. 55 B.R. 814 (Bankr. M.D. Ala. 1985), *rev'd*, *Rio v. Army Aviation Ctr. Fed. Credit Union*, 82 B.R. 138 (Bankr. M.D. Ala. 1986).

balance between debtor and creditor established by Congress in section 362.¹⁰⁵ Creditors were broadly stayed from any act to exercise control over property of the estate and the court refused to shift the balance by countenancing use of the freeze.¹⁰⁶ Because the scope of the stay is broad, the court believed that exceptions should be narrowly construed, especially when these exceptions could harm the debtor's rehabilitation efforts.¹⁰⁷

Finally, in *In re Executive Associates, Inc.*,¹⁰⁸ the court held that a freeze results in an unauthorized interference with the property of the debtor without leave of court.¹⁰⁹ The court advised that if the bank believes that a debtor is using cash collateral without having provided adequate protection, the bank should seek relief from the court.¹¹⁰ Moreover, the court posited that if creditors were allowed to determine unilaterally that they possessed a setoff right which the debtor was violating, the orderly administration of the estate would be upset.¹¹¹ The court saw the administrative freeze as equivalent to the bank granting itself an ex parte temporary restraining order in contravention of the Code.¹¹²

The above cases demonstrate that the courts which hold that the administrative freeze violates the automatic stay rely upon the broad application of the stay's policy and language.¹¹³ These courts consider the freeze to be an unwarranted, extra-judicial determination which Congress sought to avoid via the stay provision and other specific provisions in the Code allowing for relief from the stay.¹¹⁴ The cases stress the need for an orderly administration of the estate, especially to prevent interruption of the debtor's business in Chapter 11 reorganizations, which the freeze is said to disrupt.¹¹⁵

105. *Id.* at 818.

106. *Id.* at 818-19.

107. *Id.* at 819.

108. 24 B.R. 171 (Bankr. S.D. Tex. 1982).

109. *Id.* at 172.

110. *Id.* at 173.

111. *Id.*

112. *Id.*

113. *See, e.g.,* First Connecticut Small Business Inv. Co. v. Bank of Boston Connecticut (*In re* First Connecticut Small Business Inv. Co.), 118 B.R. 179, 182-83 (Bankr. D. Conn. 1990) (holding that because the automatic stay is a crucial provision of the Code which should be construed broadly, exceptions are to be read narrowly.).

114. *See, e.g.,* *In re* Executive Assocs., Inc., 24 B.R. 171, 173 (Bankr. S.D. Tex. 1982); *In re* Quality Interiors, Inc., 127 B.R. 391, 395 (Bankr. N.D. Ohio 1991).

115. *See, e.g.,* *In re* Quality Interiors, Inc., 127 B.R. at 394.

The anti-freeze cases can be criticized in two ways. First, the courts fail to consider that the stay should act merely to delay the enforcement of the creditor's rights pending an examination of the parties' respective positions.¹¹⁶ Because the decisions would allow for dissipation of collateral when it is unwarranted, they violate this policy of the automatic stay.¹¹⁷ Second, holding that an administrative freeze violates the stay ignores the policy of rewarding a creditor who declines to set off before a petition is filed.¹¹⁸ By preventing the creditor from using a freeze, the courts create an incentive for the creditor to exercise the setoff right prepetition, which could precipitate a bankruptcy.¹¹⁹ In general, the cases which refuse to allow an administrative freeze are too debtor-oriented without taking into account the creditor's interest.

B. Cases Which Hold That the Freeze Does Not Violate the Stay

In *In re Crispell*,¹²⁰ the court ruled that the right to freeze an account is implied by reading sections 362, 542 and 553 together.¹²¹ However, the court found that a continuation would have the same effect upon a debtor as if the steps for a setoff had been carried out.¹²² Therefore, the court held that if within seven days following the imposition of the freeze, the creditor did not turn over the funds to the trustee or request the court to allow an exercise of the right of setoff, the freeze would be a willful

116. 11 U.S.C. § 362 (1988). See *Johnson & O'Leary*, *supra* note 14, at 602-03; *Williams*, *supra* note 8, at 55-56.

117. By disallowing a freeze in a liquidation proceeding, the courts would allow debtors to withdraw funds from their accounts. This would affect creditors' setoff rights because their security interests in the accounts would be diminished. This substantive effect should not be the result of applying the statute. See *supra* note 116 and accompanying text.

118. See *Williams*, *supra* note 8, at 56 ("[T]his line of cases completely ignores the Code's undeniable policy of rewarding a creditor who declines to setoff before the bankruptcy petition is filed.").

119. See *id.* ("[T]his line of cases promotes prepetition setoff."). Section 553(b) weakens this argument because it allows a trustee to recover the amount offset within 90 days preceding bankruptcy subject to the improvement in position test. 11 U.S.C. § 553(b) (1988).

120. 73 B.R. 375 (Bankr. E.D. Mo. 1987)

121. 73 B.R. at 379. The court noted that a bank's right to setoff is specifically recognized by section 553(a). *Id.* Moreover, section 542(b) permitted the bank to except funds subject to the right of setoff from turnover to the trustee. *Id.* Further, the freeze did not amount to a setoff because the bank did not even decide to exercise its right to setoff by the freeze. *Id.* The clear conclusion to be drawn was that a freeze is recognized by the Code. *Id.*

122. *Id.*

violation of the stay.¹²³

In *In re Carpenter*,¹²⁴ the court reached a conclusion in accord with the *Crispell* court's holding. The court found that the legislative history of the Bankruptcy Reform Act of 1978¹²⁵ indicated that there is little justification for applying the automatic stay to setoffs in liquidation cases.¹²⁶ Therefore, applying the stay to a freeze, which is merely a method to protect setoff rights, would not be required.¹²⁷ The court, however, conditioned this right to freeze upon the creditor-bank seeking relief promptly after its imposition.¹²⁸ The court concluded by stating that if banks could not freeze, they would have to make frantic ex parte motions for relief or wait while funds were dissipated from the account.¹²⁹

123. *Id.* at 379-80. In applying the announced rule to the case at hand, the court held that the freeze did indeed violate the stay. However, because the case was one of first impression and because the bank was not unreasonable in turning over the funds to the debtor beyond seven days after the freeze and then requesting an order prohibiting use of the cash collateral, the court would not deem the violation willful. *Id.* at 380. Thus, the bank avoided liability for punitive damages, attorneys' fees or contempt of court. *Id.*

The case also provides another example of the problems with unilateral determination of the right to setoff. The court denied a motion to alter the judgment on the debtor's argument that the bank knew it had no right to setoff and thus its freeze was a willful violation. 73 B.R. at 381. The court found that the bank had not analyzed the debtor's deposits and thus had no knowledge of whether the deposits consisted of prebankruptcy or postbankruptcy earnings. *Id.* Therefore, the bank did not have the requisite knowledge for a willful violation of the stay. *Id.* To the extent that the bank was given no duty to investigate, this result is debatable. If the court would allow the bank the right to initially freeze for seven days before moving the court to exercise a setoff or turning over the funds to the trustee, then the court should have required at least a reasonable investigation by the bank to ascertain if it had the right to setoff. Such investigation would be consistent with the policy behind the automatic stay provision of section 362. *See supra* notes 14-15. To the extent that a bank is unreasonably in error, the court's decision allows an unjustified interference with the debtor's right to the funds.

124. 14 B.R. 405 (Bankr. M.D. Tenn. 1981).

125. Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified as amended at 11 U.S.C. §§ 101-1330 (1988)).

126. 14 B.R. at 407.

127. *Id.*

128. *Id.* The court noted that Congress had distinguished between withholding payment and the exercise of a setoff right in section 542. The phrase "may be offset" in section 542 contemplated that property to which the right of setoff existed, but which had not yet been offset, could be withheld from turnover to the trustee. *Id.* This result provided further support for the court because the Code specifically barred setoffs. *Id.* In contrast, the court's assertion that relief from the stay must be sought was not explained in the opinion. A logical conclusion given the court's reliance on the distinction between withholding and setoff is that, like the *Crispell* court, *In re Crispell*, 73 B.R. 375 (Bankr. E.D. Mo. 1987), the court believed that continuing the freeze amounted to a setoff.

129. 14 B.R. at 407-08. *See also In re Gillis*, 92 B.R. 461, 470-71 (Bankr. D. Haw., 1988) ("If a bank 'freezes' or withholds funds subject to a valid setoff, the bank must promptly file a complaint seeking relief from the automatic stay in order to avoid violating the stay."). The *Gillis* court reasoned that to put the burden on the debtor to take action to recover the property, if no setoff right existed,

In *Air Atlanta v. National Bank of Georgia*,¹³⁰ the court also held that the freeze did not violate the automatic stay.¹³¹ The court first stated that if a bank transfers property of the estate after it receives notice of the filing, it does so at its own peril.¹³² The turnover would violate section 542's requirement that all property of the estate be immediately turned over to the trustee or the debtor in possession.¹³³

Moreover, the court reasoned that the clear preference which the Code allows creditors regarding their setoff rights dictated the result.¹³⁴ This was true even if the freeze and subsequent setoff of bank deposits jeopardized a debtor's ability to reorganize.¹³⁵

In *In re Hoffman*,¹³⁶ focusing on the bank's dilemma under section 542, the court held that the freeze did not violate the stay.¹³⁷ The court further noted that the effect of the freeze is to maintain the status quo.¹³⁸ Therefore, the freeze is not an attempt to improve the bank's right to distribution of estate assets.¹³⁹ By implication, it would not violate one

would subject the debtor to the very pressure which the stay was designed to eliminate. 92 B.R. at 471.

130. 81 B.R. 724 (N.D. Ga. 1987).

131. *Id.* at 725 ("[T]he court is of the opinion that the approach used by the bankruptcy court in this case is the correct one, i.e., that an administrative freeze does not constitute a violation of the stay in these circumstances."). *Air Atlanta* filed a voluntary petition under Chapter 11. *Id.* After the bank learned of the filing of the bankruptcy, it refused to honor any checks drawn by *Air Atlanta* on its accounts, through the use of a freeze. *Id.* The bank moved for relief from the stay to set off two days later and *Air Atlanta* filed a complaint seeking turnover of the funds in the account to it as debtor in possession. *Id.* The bankruptcy court held that the freeze did not violate the stay. *Id.*

132. *Id.* at 726.

133. *Id.* at 725-26.

134. *Id.* at 726.

135. *Id.* See also *Stann v. Mid Am. Credit Union*, 39 B.R. 246, 248 (D. Kan. 1984). The *Stann* court argued that the freeze does not violate the stay because it is not a setoff for three reasons: (1) a setoff requires an overt act, while a freeze is merely inaction on the part of the bank; (2) a setoff adjusts the rights of the parties but a freeze does not; (3) the freeze is necessary to secure the bank's setoff right by preventing withdrawal of funds. 39 B.R. at 247-48.

This decision may be criticized for providing too narrow a focus. Even if the freeze did not amount to a setoff, it could still violate other provisions of the automatic stay. However, the court did not address this possibility.

136. 51 B.R. 42 (Bankr. W.D. Ark. 1985)

137. *Id.* at 46. The court noted that if a bank transfers property of the estate after learning of the filing of a bankruptcy petition, it could be subject to liability to the estate for the amount transferred. *Id.* Section 549 authorizes the trustee to set aside unauthorized transfers of property of the estate. *Id.* Section 542 only protects a transfer without notice and in good faith. *Id.* Therefore, the court reasoned that by honoring withdrawals on the account, the bank would be violating the Code's turnover provisions. *Id.*

138. *Id.*

139. *Id.*

policy behind the automatic stay provision—to provide for the orderly administration of the estate.¹⁴⁰

The court in *Kenney's Franchise Corp. v. Central Fidelity Bank*¹⁴¹ focused on the cash collateral provisions of section 363. The court noted that section 363(c)(2) “provides that the trustee may not use cash collateral without the authorization of the bankruptcy court, following notice and hearing.”¹⁴² Therefore, the bank acted properly in not allowing the debtor to use the checking account without prior court approval.¹⁴³ The court concluded that: (a) the funds in the bank account were cash collateral; (b) accordingly, Kenney's could not use the proceeds of the account without the bank's consent or the approval of the court; and (c) as no consent or approval was given, the bank's actions in freezing the funds until an adequate protection hearing were entirely proper.¹⁴⁴

The court in *In re Lee*¹⁴⁵ focused on the adequate protection feature of section 363. The court held that because the bank holds a secured claim

140. *Id.* The court's assertion was not entirely correct. While it is true that the freeze does not result in affirmative activity in the account, it does disturb what would occur had the freeze not been imposed. Without a freeze, the debtor would have access to the funds in the account, and the bank would have to file for relief from the stay in order to set off and protect its interest. Indeed, the freeze is an attempt to improve the bank's right to distribution by protecting its setoff rights. Of course, the use of setoff itself violates the tenet of equality of treatment to unsecured creditors, but it is justified by its long history in the Code. To go beyond the right to setoff by freezing the account is an expansion of the setoff exception to the general rule of no preferences for unsecured creditors and should be limited in scope as argued in this Note. *Accord* Heckathorn Constr. Co. v. Bass Mechanical Contractors, Inc. (*In re* Bass Mechanical Contractors, Inc.), 84 B.R. 1009, 1022-23 (Bankr. W.D. Ark. 1988) (noting that placing a freeze on a debtor's account operates to preserve the debtor's account and is not a direct or indirect attempt to improve the bank's right to a distribution of assets); *In re* Learn, 95 B.R. 495, 497 (Bankr. N.D. Ohio 1989) (“[A]n administrative freeze simply preserves the status quo until the rights of the parties may be judicially determined.”)

141. 22 B.R. 747 (W.D. Va. 1982) (overruling *In re* Kenney's Franchise Corp., 12 B.R. 390, 394 (Bankr. W.D. Va. 1981)).

142. *Id.* at 749.

143. *Id.*

144. *Id.* at 750. *Accord* *In re* Owens-Peterson, 39 B.R. 186 (Bankr. N.D. Ga. 1984). The *Owens-Peterson* court held that while the result could potentially impose a burden on a reorganization debtor, the result is inescapable once the court determines that the bank account constitutes cash collateral under section 363. 39 B.R. at 189. The court concluded that a freeze must be allowed pending final resolution by the court on a motion by the bank for relief from the automatic stay to complete setoff or a motion by the debtor to use cash collateral or a complaint for the turnover of funds. *Id.*

This restrictive approach to the freeze is criticized in part V of this Note. *See also* *In re* Gazelle, Inc., 17 B.R. 617, 620 (Bankr. W.D. Wis. 1982) (holding that freezing the account was entirely proper because funds were cash collateral, the use of which was prohibited absent bank consent or court authorization).

145. 40 B.R. 123 (Bankr. E.D. Mich. 1984).

under section 506 to the extent of its right to setoff, the trustee or debtor in possession has no right to the funds unless the trustee or debtor convinces the court that the creditor is adequately protected under section 363.¹⁴⁶ The court further noted that requiring a turnover without a court order makes no sense because it allows the funds in the account to be dissipated without providing the bank with its right to adequate protection.¹⁴⁷ In these cases, it is proper to mandate that the trustee or debtor in possession move for use of the funds rather than subject the creditor to the possible risk of losing its security interest.¹⁴⁸

Similarly, in *In re Edgins*,¹⁴⁹ the court argued that disallowing the administrative freeze placed the burden upon the wrong party.¹⁵⁰ Creditors with a valid setoff right should not be required to turn over the funds and then subsequently be required to obtain an order to preclude the debtor from dissipating the account.¹⁵¹ The court noted that a contrary finding would result in the shield of section 362 being used as a sword to divest the bank of its legitimate interest in the funds pursuant to its setoff right.¹⁵²

146. *Id.* at 126.

147. *Id.*

148. *Id.* The court further recognized that a Chapter 7 debtor is not the proper party to raise a violation of section 362(a)(7) [the automatic stay of a setoff]. The court's rationale was that the provision was meant to make funds available for the operation of a business in a reorganization case. *Id.* The author believes that this reading of the Code is entirely correct. A liquidated debtor has no interest in the operation of a business because there is no business left to run.

149. 36 B.R. 480 (Bankr. 9th Cir. 1984).

150. *Id.* at 484. The court first concluded that section 542(d) counteracts the bank's action to preclude the debtor's use of the funds pending a determination of the bank's right to setoff. *Id.* at 483. The court then stated that section 363 did not require that the bank bring an action to deter payment of account funds. *Id.* Therefore, the burden should be on the debtor to bring a claim for use of the funds. *Id.* at 484.

151. *Id.*

152. *Id.* Accordingly, the bank's reaction to the problem was a proper attempt to maintain the status quo and to create a balance pending prompt action by either party to resolve the rights of the parties to the funds. *Id.* at 484-85.

The court appears to have agreed with the *Wildcat* court, *In re Wildcat Const. Co.*, 57 B.R. 981 (Bankr. D. Vt. 1986), that the statute creates a stalemate. *Id.* at 483. The court noted that the Code does not specify whether the creditor should bring an action for relief from the stay or the debtor should bring a motion for use of cash collateral to "break what appears to be a statutory logjam." *Id.* However, the court did not consider this sufficient protection for the bank and thus allowed the bank to freeze to protect its interest. *Id.*

In addition, the court stated that it would be appropriate for the debtor to move for use of the funds as cash collateral under section 363. *Id.* Because the debtor has knowledge of the impending bankruptcy and control of subsequent events, the debtor must initiate proceedings to determine the proper disposition of the funds. *Id.* at 483-84.

In *In re Williams*,¹⁵³ the court held that the solution to the problem of the administrative freeze lay in applying a longstanding rule of statutory construction.¹⁵⁴ The rule holds that where there is a specific provision and a general one in the same statute, the specific provision controls and the general one should be limited to those cases which do not fall within the language of the specific provision.¹⁵⁵ In this case, the court stated that the specific permission granted to the creditor to retain funds subject to set off in section 542 should prevail over the general prohibitions in section 362.¹⁵⁶ Therefore, the court concluded that a freeze should be allowed until an order is entered providing for the disposition of the funds.¹⁵⁷

In summary, the cases holding that the freeze does not violate the stay focus on either the dissipation of the bank's cash collateral and resulting destruction of the setoff right¹⁵⁸ or on the dilemma the bank encounters if no freeze is allowed.¹⁵⁹ In many contexts, the cases provide the

This reading is open to attack as being contrary to the Code's policy of debtor repose. To the extent that the bank wishes to prohibit the use of the funds, an equally persuasive argument is that the burden should be on the bank. The bank is trying to avoid the effect of the stay so it should be required to move for relief. This result could be seen as mandated by section 362's provision for relief from the stay. See *Craddock-Terry Shoe Corp. v. Crestar Bank (In re Craddock-Terry Shoe Corp.)*, 91 B.R. 392 (Bankr. W.D. Va. 1988). See also *Citizen Bank of Maryland v. Strumpf*, 138 B.R. 792, 794 (Bankr. D. Md. 1992) (arguing that the freeze is the only sensible procedural approach because the bank's right to setoff would be rendered meaningless through dissipation of the funds prior to a motion for relief from the stay); *Rio v. Army Aviation Ctr. Fed. Credit Union*, 82 B.R. 138, 144 (Bankr. M.D. Ala. 1986) ("[T]he imposition of the administrative hold on the account of the Debtors was a reasonable means by which the Credit Union could assure that the Bankruptcy Court's options would be preserved and that the Credit Union's right in the collateral would be adequately protected.")

153. 61 B.R. 567 (Bankr. N.D. Tex. 1986).

154. *Id.* at 573.

155. *Id.* (quoting 73 AM. JUR. 2D *Statutes* § 257 (1974)).

156. *Id.*

157. *Id.*

158. See 4 COLLIER, *supra* note 17, ¶ 553.15, at 553-86 ("[I]t is argued [by courts allowing the administrative freeze], the Code contemplates that the debtor must apply to the court before it can use funds on deposit . . . to the extent that the bank may have a right to set off such funds."). "Section 363(c)(2) provides that the trustee may not use cash collateral unless the other entity with an interest consents or unless the court authorizes such use after notice and hearing." *Id.*

159. If the bank cannot freeze, several problems may result. First, if the bank turns over the funds in the account, it could be liable under section 542. That section implicitly makes an entity with knowledge of the bankruptcy filing that turns over funds belonging to the estate liable for the amount which is turned over. 11 U.S.C. § 542 (c). Thus, it could be argued, the bank cannot avoid this result by applying an administrative freeze.

Further, the bank would lose its right to setoff because funds have been removed from the account, and the bank would lose its right to adequate protection for use of those funds. Both of these outcomes arguably violate the Code provisions, section 553 and 363, which recognize those creditor rights. Finally, the bank would be helping the debtor violate the Code by allowing use of cash collateral

appropriate balance between the conflicting interests of the creditor seeking a right to setoff and the debtor whose funds are subject to the setoff. The creditor's interest is protected while the debtor can seek permission to use the cash collateral by filing a motion pursuant to section 363(e).

In other situations, however, the arguments in favor of the administrative freeze lose their force. For example, in a reorganization context, the right of a debtor to obtain the funds to meet operating expenses should trump the concerns of the bank. The debtor should be able to tap as many resources as possible to obtain cash in order to reorganize successfully. The pro-freeze cases would make it less likely that a debtor would be rehabilitated, to the detriment of all parties. Allowing a freeze would necessitate the debtor's seeking approval of use of the funds, and this would be too lengthy a delay.

The statutory construction approach of *In re Williams*¹⁶⁰ may also be attacked. Although the court properly noted that a specific provision controls a more general one, an equally important rule of statutory construction states that provisions should be construed as consistent with one another.¹⁶¹ Section 542(b) merely states that a creditor need not turn over funds to the trustee who has a right to setoff.¹⁶² Section 542(b) does not allow a creditor to act unilaterally to prevent the debtor from accessing those funds.¹⁶³ Therefore, the section does not permit action by the creditor, which arguably comes within the prohibition of the automatic stay, because there is no conflict with section 362.¹⁶⁴ Thus, there is no conflict which would mandate the rule utilized by the *Williams* court.¹⁶⁵

IV. THE ELEVENTH CIRCUIT'S NOVEL SOLUTION IN *IN RE PATTERSON*

In *In re Patterson*,¹⁶⁶ a credit union's loan to Chapter 13 debtors was

without consent or authorization. This argument, however, is the bank's weakest because it is not the creditor's obligation to ensure compliance with the Code provisions.

160. 61 B.R. 567 (Bankr. N.D. Tex. 1986).

161. See *First Connecticut Small Business Inv. Co. v. Bank of Boston Connecticut (In re First Connecticut Small Business Inv. Co.)*, 118 B.R. 179, 182 (Bankr. D. Conn. 1990) ("Whenever possible, statutory provisions should be construed so as to be consistent with each other.") (citing *Citizens to Save Spencer County v. EPA*, 600 F.2d 844, 870 (D.C. Cir. 1979)).

162. 11 U.S.C. § 542(b) (1988). See *In re First Connecticut Small Business Inv. Co.*, 118 B.R. at 182.

163. *In re First Connecticut Small Business Inv. Co.*, 118 B.R. at 182.

164. *Id.* at 182-83.

165. *Id.* at 183-84.

166. 967 F.2d 505 (11th Cir. 1992).

secured by the debtors' checking and savings accounts.¹⁶⁷ Because the outstanding loan exceeded the balance in these accounts, the credit union applied an administrative freeze when it learned that the debtors filed for bankruptcy.¹⁶⁸ The credit union justified its freeze by stating that the freeze merely protected the credit union's right to setoff, which is preserved under the Code. Therefore, the freeze did not violate the automatic stay.¹⁶⁹ The right to setoff, the credit union argued, would be an empty right if the debtors could draw on the account and destroy the creditor's security.¹⁷⁰

The court joined the cases holding that the freeze violates the automatic stay and held that the freeze violates the policy of the Code.¹⁷¹ The court argued that section 553 preserves the right to setoff only to the extent that the right is valid, and the Code sets forth the procedure for the bankruptcy court to determine whether a creditor is entitled to set off.¹⁷² Thus, freezing the account to protect a valid right of setoff only begs the question whether there is a valid right.¹⁷³ The court further noted that although

167. *Id.* at 507. The plaintiffs had joined the B.F. Goodrich Employees Federal Credit Union, which maintained the plaintiffs' savings and checking accounts and to which they were indebted on a loan. *Id.* The note on the loan provided that the Pattersons' accounts served as security for the loan. *Id.*

168. *Id.*

169. *Id.* at 508.

170. *Id.* at 509. In response to the Credit Union's actions, the plaintiffs filed two proceedings against the Credit Union: first, they requested a turnover of funds frozen by the Credit Union; and second, they moved for an injunction restraining the Union from closing their accounts. *Id.* at 508. The Credit Union responded, moving to lift the stay, in order to apply the assets in the frozen accounts to the plaintiffs' loan obligation. *Id.* The plaintiffs eventually consented to this motion and withdrew their motion for the turnover of funds. *Id.* Subsequently, the court granted the plaintiffs' motion to restrain the Credit Union and awarded damages and attorney's fees to the plaintiffs for the Credit Union's violation of the automatic stay. *Id.* The Credit Union appealed this ruling to the United States District Court for the Northern District of Alabama, which affirmed the bankruptcy court. *Id.*

171. *Id.* at 510. The court specifically found a violation of section 362(a)(3) because the freeze constituted an act to exercise control over the property of the bankruptcy estate. *Id.* at 511-12. The freeze deprived the plaintiffs of any control over the funds and invested exclusive control in the Credit Union. *Id.* at 512. The court noted that such an application would be subject to criticism as being too broad and eviscerating provisions meant to protect creditors. *Id.* However, the court stated that its solution would result in an abdication of control by the creditor, thus balancing the interests of the debtor and the creditor and giving effect to the broad language of section 362(a)(3). *Id.*

The court also found the freeze violated section 362(a)(4) as an act to enforce a lien against property of the estate. *Id.* The freeze was a unilateral determination of a valid setoff right because it relied on a lien created by the state law. *Id.* Further, the freeze violated section 362(a)(6) as an act to collect a pre-petition debt. *Id.*

172. 967 F.2d at 510.

173. *Id.*

the freeze is a unilateral determination that the setoff is valid, the Code provides for a judicial determination of a valid right to setoff and thus dispenses with creditor self-help.¹⁷⁴

The *Patterson* court recognized the concern of the credit union that the court's holding could make a creditor's setoff rights nonexistent.¹⁷⁵ However, the court refused to acknowledge that a credit union could protect its interest only through an administrative freeze.¹⁷⁶ Rather, the court noted that the creditor may file an ex parte motion pursuant to sections 362(f) or 363(e) and accompany the motion with funds to be paid into the registry of the bankruptcy court.¹⁷⁷ This procedure would protect the interests of both parties—the creditor is protected from a removal of funds, and the debtor is protected from an erroneous unilateral determination of the creditor that it possesses a valid right of setoff.¹⁷⁸

V. ANALYSIS OF THE *PATTERSON* SOLUTION AND A PROPOSAL

A. Analysis of Patterson

The *Patterson* decision provides a fresh solution to an old problem. The discussion in Part III of the cases interpreting the freeze illustrates the logjam created by merely deciding whether the freeze violates the automatic stay. Such a broad determination without a consideration of the context of the litigation is made impossible by the competing policies and the lack of direction provided by the Code on this issue. Realizing this difficulty, the court in *Patterson* correctly adopted a functional approach which balanced the competing interests of the creditor and the debtor.

The court's procedure avoided the problems associated with using the

174. *Id.* The court noted that the case demonstrated the inherent flaw in using the freeze as a means to protect a valid right to setoff. *Id.* The Credit Union was mistaken in its assertion of its right to setoff because the "right of setoff had not yet ripened." *Id.* The plaintiffs had not failed to make a payment when the freeze was imposed, and therefore, under Alabama law, there was no mutuality. *Id.* at 511.

175. "If the Credit Union's right to setoff were later determined valid, and if the funds in the account had been disbursed to payees, then the Credit Union's right to setoff would indeed be an empty right." 967 F.2d at 511.

176. *Id.*

177. *Id.*

178. 967 F.2d at 511-513. The *Patterson* court's analysis was followed by the court in *In re Flynn*, 143 B.R. 798, 801-02 (Bankr. D.R.I. 1992). The *Flynn* court held that the Code prohibited the freeze under section 362(a)(3) as a self-help mechanism. *Id.* at 801. However, the *Flynn* court adopted *Patterson*'s rule to prevent creditor abuses and to protect against debtors unfairly depleting estate assets. *Id.* at 802.

freeze by establishing a workable alternative. Because the court would render the determination of the rights of the parties, the creditor's actions would not be open to automatic stay prohibitions.¹⁷⁹ Further, the *Patterson* court's approach envisioned that the court could ensure the protection of the various rights of the parties concerning setoff, adequate protection, and the cash collateral.¹⁸⁰ Therefore, the procedure would fulfill the goal of an orderly administration of the estate while providing the debtor with relief and protection from unilateral action by the creditor.

Despite its fresh approach, there are some flaws to the court's reasoning in *Patterson*. First, it is not clear that the provisions cited by the court would allow for a full determination of the parties' rights. For example, under section 363(e), the focus is upon the debtor. In this context, the creditor's right to setoff would be ignored because, under this section, the only issue is whether the creditor is offered adequate protection by the trustee.¹⁸¹ While it is true that the burden of proof on adequate protection would rest with the trustee, the proceeding would still only concern use of the cash collateral and not the creditor's right to setoff.¹⁸²

Importantly, if the court believed that section 363(e) proceedings must be expanded, it was not clear how the court reached this decision. The court simply stated that the proper balance between debtor and creditor rights would be struck.¹⁸³ Even if an expansion was intended by the *Patterson* court, the legislative history suggests that such an expansion would be inconsistent for either section 363(e) or section 362(f).¹⁸⁴ A Senate report states that "the only issue will be the lack of adequate

179. *In re Patterson*, 967 F.2d at 512. The court held that a creditor can file an ex parte motion pursuant to sections 362(f) or 363(e) and accompany such motion with funds from the debtor's account to be paid into the bankruptcy court registry. *Id.* Section 362 specifically envisions such a procedure and, therefore, the bank's actions would not fall within the prohibition of section 362(a). 11 U.S.C. § 362 (1988). The action would not be unilateral determination by the bank of its setoff right. It would be an "abdication of control by the creditor in favor of the bankruptcy court's determination . . ." 967 F.2d at 512.

180. *In re Patterson*, 967 F.2d at 511.

181. *See* 2 COLLIER, *supra* note 17, ¶ 363.06, at 363-29.

182. *See* Domenic L. Massary, III, *Adequate Protection Under the Bankruptcy Reform Act*, in ANNUAL SURVEY OF BANKRUPTCY LAW 171 (William L. Norton, Jr. ed., 1979); 11 U.S.C. § 363(e) (1988). Section 362's focus is entirely on whether adequate protection has been provided for the creditor's interest. Massary, *supra*, at 179. Obviously, there is no need for adequate protection if there is no setoff right. Thus, the procedure, which is meant to decide whether there is a valid right to setoff, is assumed by the motion, and the whole purpose of the court's procedure is eradicated.

183. *In re Patterson*, 967 F.2d 505, 511 (Bankr. 11th Cir. 1992).

184. *See* S. REP. NO. 598, 95th Cong., 2d Sess. 55 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5841.

protection, the debtor's equity in the property, and the necessity of the property to an effective reorganization of the debtor" in a 362(f) proceeding.¹⁸⁵ Whether a right to a setoff exists would appear to be the sort of counterclaim which would not be permitted at the hearing provided by Congress.¹⁸⁶

In addition, section 362(f) has traditionally been used only in very limited contexts.¹⁸⁷ This limited use is due to the importance of notice to the debtor before granting relief from the automatic stay.¹⁸⁸ As a result, the circumstances which have justified relief under the section have been narrow—the creditor must show an immediate and significant threat.¹⁸⁹ Therefore, the court's proposal to allow the bank to move under section 362(f) for relief from the stay would result in the section's significant expansion.¹⁹⁰ Such expansion may run into constitutional objections.¹⁹¹

Second, the court failed to give full protection to the creditor's right to a setoff permitted under state law. The right to a setoff is often a bargained-for right as part of the loan contract.¹⁹² By broadly pronouncing that a freeze is always a violation of the automatic stay,¹⁹³ the court impermissibly eliminated a needed device to protect that right in certain situations.¹⁹⁴ In response to the *Patterson* court's analysis, creditors may

185. *See id.*

186. *Id.*

187. 1 EPSTEIN ET AL., *supra* note 15, § 3.31, at 340-43; 2 COLLIER, *supra* note 17, ¶ 362.09, at 362-81; PATRICK A. MURPHY, CREDITORS' RIGHTS IN BANKRUPTCY 6-22 (2d ed. 1992).

188. 1 EPSTEIN ET AL., *supra* note 15, § 3.31, at 341; 2 COLLIER, *supra* note 17, ¶ 362.09, at 362-81.

189. *See* 1 EPSTEIN ET AL., *supra* note 15, § 3.31, at 340-43.

190. The Bankruptcy Rules mandate that the showing of irreparable damage required by the section be made, *inter alia*, by reference to specific facts shown by affidavit which establish an imminent risk. *See* 1 EPSTEIN ET AL., *supra* note 15, § 3.31, at 341. In the typical *Patterson*-type scenario, there is merely an unarticulated threat of dissipation of cash collateral. It is clear that this showing would not be sufficient under the current workings of section 362(f) to allow for relief.

191. Due process requires adequate notice before rights are affected. *See* 1 EPSTEIN ET AL., *supra* note 15, § 3.31, at 343. Because the account funds would be placed within the court's registry, the debtor's right to those funds would be hindered without prior notice of the bank's action. Therefore, there must be a compelling rationale to allow for the bank to use section 362(f), which may be lacking due to the nonspecific nature of the threat to the bank's interest. *Id.*

192. *See* Ahart, *supra* note 30, at 194-95.

193. *In re Patterson*, 967 F.2d at 510.

194. *See infra* part V.B. (arguing that the freeze should be allowed in a liquidation to protect creditors' setoff rights).

set off at the first sign of financial distress by the debtor.¹⁹⁵ Such a result would be contrary to the result bankruptcy policy seeks to achieve.

B. *A New Perspective*

Because the justification for placing an administrative freeze is to protect setoff rights, any evaluation of the bank's right to freeze must take into account the rationale for allowing a setoff.¹⁹⁶ In determining whether a creditor is entitled to setoff, a court must first look to the two overarching policies of bankruptcy: debtor protection and creditor control. While it is true that bankruptcy has evolved from a punitive, creditor-oriented model toward an affirmative, debtor's remedy,¹⁹⁷ the setoff provision reflects a balance of these competing goals.¹⁹⁸ Therefore, the court must also balance the creditor and debtor interests when ruling on the administrative freeze.

When the bank's claim to a setoff is strong, then the goal of creditor-control and equitable treatment for creditors should tip the balance in favor of permitting a freeze. In this scenario, the Code's recognition of the right to setoff should be given greater weight and the bank should be allowed to freeze the funds in the debtor's account.

Typically, a creditor's setoff right is strongest in liquidation cases.¹⁹⁹

195. See Richard Sauer, *Special Problems of Banks With Bankruptcy Debtor Customers*, 61 AM. BANKR. L.J. 95, 111 (1987) (noting that to not allow an administrative freeze will encourage bankers "to implement setoff at the first hint of a contemplated bankruptcy proceeding, which is exactly the result Congress sought to avoid[]").

196. It should be noted that the right to setoff is more restricted under the current Code than was the case under section 68 of the Chandler Act. The earlier setoff provision was considered to be too broad because certain creditors received a preference to the detriment of other creditors and the debtor's estate. 4 COLLIER, *supra* note 17, ¶ 553.02, at 553-10. Recognition of the fact that setoff, while not completely disfavored under the Code, is meant to be used in a limited context, supports a view restricting the right to use an administrative freeze.

197. The English antecedents to the current Bankruptcy Code were creditors' remedies designed to provide satisfaction for a creditor's claim. In the United States, bankruptcy evolved toward an affirmative debtor's remedy through development of affirmative procedures for the debtor, including the ability by which debt relief can be achieved without surrender of all or most of the debtor's property. See 1 WILLIAM L. NORTON, JR., *NORTON BANKRUPTCY LAW AND PRACTICE* §§ 1.01-.03 (1992).

198. Section 553 recognizes the right to setoff but limits its use in order to meet debtor's needs. See *supra* note 48 and accompanying text. For example, the setoff right is limited by the "improvement in position" test and is stayed by section 362. However, it is allowed even though it results in a preference for the creditor invoking the right. See *supra* note 48.

199. The legislative history reflects that the automatic stay in a liquidation case is meant to relieve the debtor of harassing actions by creditors seeking payment. See H.R. REP. NO. 595, 95th Cong., 2d Sess. 125 (1978), *reprinted in* 1978 U.S.C.A.N. 5963, 6086-87. In this context, the administrative

The debtor's interest in the cash collateral is limited and the repercussions of an erroneous determination of the setoff right for the debtor are not great.²⁰⁰ If an erroneous determination is made, the trustee can move for a turnover to the estate under section 542.²⁰¹ Therefore, the bank should be able to act swiftly to protect its rights.

In contrast, when the rationale for allowing a setoff in the situation before the court is weak, then the bankruptcy goal of debtor protection becomes dominant and the freeze should not be allowed. The automatic stay trumps the right of the bank to freeze in this situation because setoff is an aberration of the Code's policy not to allow preferences for unsecured creditors.²⁰² When a setoff would present problems for the resolution of the bankruptcy, a court should not allow the self-help device of the administrative freeze to protect that right. The creditor should use other remedies provided in the Code, such as the motion for relief from the stay, for protection of its setoff right.²⁰³

The debtor's rights are particularly strong in a reorganization case.²⁰⁴

freeze should not be viewed to fall within that prohibition because it is a passive act by the bank. The bank is merely maintaining the balance in the account and is not actively seeking repayment. This evaluation is mandated by the strong setoff interest of the bank in a liquidation.

200. See H.R. REP. NO. 595, 95th Cong., 2d Sess. 183 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6144. The legislative history indicates:

In a liquidation case, any setoff that occurs after the commencement of the case has no effect on the debtor. The amount that the creditor recovers through setoff will permit him to recover a higher percentage of his total claim than other creditors, but it will not interfere with the debtor's operation or business in any way, because the debtor has already gone out of business. Whether the setoff is of a bank deposit or of mutual debts and credits with another merchant or business, the effect is the same.

Id.

201. 11 U.S.C. § 542(a) (1988). This section provides that "an entity . . . in possession, custody or control during the case, of property that the trustee may use, sell, or lease under section 363 . . . , or that the debtor may except under section 522 . . . shall deliver to trustee, and account for, such property . . ." *Id.*

202. See Carmelita J. Hammon, *Setoff In Bankruptcy: Is the Creditor Preferred or Secured?*, 50 U. COLO. L. REV. 511, 512 (1979); John C. McCoid III, *Setoff: Why Bankruptcy Priority?*, 75 VA. L. REV. 15, 19 (1989).

203. Note that the analysis does not turn on whether the right to setoff should be recognized in a certain context. The Code has already provided that the setoff right is preserved in bankruptcy. 11 U.S.C. § 553. Rather, the question is whether a court should allow the use of an administrative freeze in order to protect that right. As the freeze is an extra-judicial or self-help mechanism for the bank, its use should be limited to those situations in which the setoff right is least problematic for the debtor and when the rationale for setoff is highest. This occurs most frequently in the liquidation context.

204. See H.R. REP. NO. 595, 95th Cong., 2d Sess. 183 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6144. The legislative history states:

The situation for the treatment of setoff in a reorganization case is very different than in a liquidation case. In order to accomplish a successful reorganization, it is important that

There, the cash collateral represents the very lifeblood of the business.²⁰⁵ An erroneous determination of the bank concerning the right to setoff can have disastrous effects on the debtor's reorganization efforts.²⁰⁶ Therefore, the court should demand that a judicial determination of the right to setoff be made before the bank acts against the account by freezing it.²⁰⁷ Because the rationale for a setoff is weak, the balance between the policies of debtor protection and creditor control favors allowing use of the funds until the creditor seeks a positive ruling from the court.

Thus, under the proposed analysis, determination of when the rationale for the setoff is strong or weak is made by reference to the type of proceeding before the court. The use of the administrative freeze would not be a violation of the stay in a liquidation but would be a violation in a reorganization.

This paradigm is an improvement on the *Patterson* decision because it does not broadly discount the freeze. The *Patterson* decision is overinclusive for it disapproves of the freeze when it is justified and,

business proceed as usual for the debtor. Setoff is an interruption in the conduct of business, and may have detrimental effects on the attempted reorganization . . . [s]etoff in the reorganization context makes reorganization more difficult, because it deprives the debtor of the use of its cash on deposit with banks.

Id.

205. See *M Bank Dallas, N.A. v. O'Connor (In re O'Connor)*, 808 F.2d 1393, 1397-98 (10th Cir. 1987). The court stated:

Debtors . . . have proposed to deal with cash collateral for the purpose of enhancing the prospects of reorganization. This quest is the ultimate goal of Chapter 11. Hence, the Debtors' efforts are not only to be encouraged, but also their efforts during the administration of the proceeding are to be measured in light of that quest. Because the ultimate benefit to be achieved by a successful reorganization inures to all the creditors of the estate, a fair opportunity must be given to the Debtors to achieve that end.

Id.

206. In their article, Benjamin Weintraub and Alan N. Resnick conclude that because the funds are cash collateral, the right of the debtor to their use, without approval, is no greater than the bank's right to withhold. Weintraub & Resnick, *supra* note 3, at 324. Therefore, the freeze should be permissible pending a determination of the adequacy of the bank's protection upon the debtor's request for use of the funds. *Id.* This analysis is flawed for it ignores the need for businesses to use the collateral to reorganize successfully. By refusing to look at the freeze within a specific context, and by stressing the bank's interest in preventing dissipation of the account, the authors fail to realize that the right of the debtor to use the collateral would trump the right of the bank to withhold.

207. This result is further dictated by the realization that the purpose of the automatic stay in a Chapter 11 context is to facilitate a reorganization. See *supra* note 14. It is to preserve the secured creditors position, within equitable limits, during the filing of the case and the confirmation of a plan of reorganization. See *Central Trust Co. v. Mr. D. Realty Co. (In re Mr. D. Realty Co.)*, 27 B.R. 359, 364 (Bankr. S.D. Ohio 1983). This policy would mandate that the freeze be stayed to facilitate the reorganization and to provide equitable relief to the debtor.

thereby, unnecessarily requires creditors to seek hasty *ex parte* relief.²⁰⁸

This paradigm also represents an improvement on the cases which hold that the freeze violates the stay in all situations. Those decisions focus on the broad application of the automatic stay provision without discussing the policy justifications for such an application. The cases divorce the stay from its underpinnings and do not permit the freeze when the very rationale behind the stay would dictate its use.

The paradigm is likewise an improvement on the cases which hold that the freeze does not violate the stay. Those decisions unnecessarily stress the cash collateral and turnover provisions of the Code.²⁰⁹ Moreover, those cases fail to consider adequately the debtor's interest by stating that the creditor is merely complying with the policy of the Code in freezing the account and preserving its setoff interests.²¹⁰

As for the turnover rationale, it is unpersuasive that an administrative freeze should be allowed to avoid an implied violation of section 542(c). Under section 542(b), a creditor with a right to setoff need not turn over property to the trustee.²¹¹ Thus, the only time a creditor with knowledge of a filing could be liable to the estate is if it turned over property of the estate to third persons when it had no right to setoff.²¹² This dilemma may not be solved by a freeze because a freeze is designed merely to protect a setoff right.²¹³ A bank that froze an account in which it held no right to setoff would be overreaching and should be prohibited from doing so by the automatic stay.

208. The use of a freeze would be justified in a liquidation context which the *Patterson* decision would not recognize.

209. See *supra* part III.B.

210. That this right has been overly stressed can be seen by reference to McCoid, *supra* note 202, at 43. Professor McCoid cogently notes that historical and contemporary justifications for setoff in bankruptcy are unsound. The natural justice rationale for setoff portrays bankruptcy as a duel between a creditor with a setoff power against the debtor's interests rather than against other creditors. *Id.* This justification became misplaced with the advent of discharge. *Id.* at 16. Further, the security rationale for setoff provides a preference when the relationship of mutual obligation between debtor and creditor does not warrant giving that creditor a priority. *Id.*

211. Section 542(b) provides an exception for creditors' with setoff rights. An entity that owes a debt which is property of the estate must put the debt to the trustee, "except to the extent that such debt may be offset under section 553." 11 U.S.C. § 542(b) (1988).

212. If the creditor had a right to setoff, then section 542(b) exempts the creditor from turning over property subject to the setoff right to the estate. *Id.*

213. See Wynn, *supra* note 2, at 86-87; Weintraub & Resnick, *supra* note 3, at 318.

VI. CONCLUSION

The ultimate issue is whether a creditor should be allowed the extra-judicial, self-help device of the administrative freeze in order to protect its setoff rights stated by the Code. When the claim to such a right is strongest the creditor should be allowed to use the freeze and the debtor may seek use of the funds under section 363. When the rationale for a setoff is weak, the freeze should be disallowed and the creditor should seek to prohibit use of funds under section 362 or 363.

This proposal is an interpretive device which can be used by courts to make sense out of the competing policies and language of the Code provisions. The approach attempts to provide a fresh alternative for a court faced with an administrative freeze problem by putting forth a policy-based rationale for decisions. This approach reconciles the competing rationales and language of both the Code sections and the cases interpreting those sections.

Scott T. Silverman