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FREEZING THE DEBTOR'S BANK ACCOUNT AND THE AUTOMATIC STAY

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In recent years, a considerable number of courts have addressed the issue of whether a bank may freeze a debtor's bank account upon receiving notice of the debtor's bankruptcy filing, and whether the freeze violates the automatic stay provisions of the Bankruptcy Code. One purpose of the freeze (sometimes called an "administrative freeze" or an "administrative hold") may be to preserve a right of setoff. Another purpose is to avoid liability for allowing improper payments on prepetition debts. Courts have split on this issue.

BACKGROUND

The cases discussing whether an administrative freeze violates the automatic stay generally involve a similar fact pattern. A bank or other financial institution receives notice of the debtor's bankruptcy filing, and responds by placing a freeze on the debtor's deposit or checking account. The freeze prohibits the debtor from accessing the funds in the account. The debtor usually will have a loan with the bank, and the bank would like to preserve its right of offset by freezing the debtor's account.[1] The freeze is only temporary, until the bank's right of setoff is judicially determined. The administrative freeze has been challenged in a number of cases by debtors who claimed that the freeze was a violation of the automatic stay.[2] Because the issue involves the interplay of several different sections of the Code, the courts have split[3] on the issue of whether a bank may freeze a debtor's bank account upon receiving a notice of the debtor's bankruptcy.

Cases Holding that a Freeze is a Violation of the Stay

Although at least one court has held that the administrative freeze violates the automatic stay provisions under several subsections of Section 362(a),[4] the courts generally focus on Section 362(a)(3) of the Code. Section 362(a)(3) generally provides that a filed petition stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate. . ."[5]

The part of Section 362(a)(3) relating to "exercis[ing] control" provides the primary authority for the courts to conclude that an administrative freeze is a violation of the automatic stay. The Eleventh Circuit recently addressed this issue in *In re Patterson.*[6] In Patterson, the court ruled that the freeze deprived the debtors of "any control over those funds," and "invested exclusive control" in the credit union.[7] Hence, the court

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ruled that the administrative freeze violated the automatic stay.

Second, courts have pointed out that the automatic stay is intended to prevent a creditor from making unilateral determinations of its right to setoff.[8] If the bank errs in its determination of its right to setoff, the bank will have improperly impaired the debtor's ability to access the funds in the account. The courts deem the freeze as self-help that is prohibited by the Code.[9]

Third, the freeze could tie up more money than is actually owed to the bank. For example, the debtor may have $10,000 in his account, but only owe the bank $5,000. However, the full $10,000 will usually be frozen by the bank. Even if the bank is entitled to the setoff, the bank has prevented the debtor from accessing the extra funds to which the debtor is entitled. If a bank's freeze is valid, then the debtor's chances for successful rehabilitation are substantially diminished in the context of a Chapter 13 reorganization.[11] Arguably, an interpretation of Section 362 that a freeze does not violate the automatic stay is inconsistent with the general scheme of the Bankruptcy Code.[12]

Cases Holding That a Freeze of Account Is Not a Violation of the Automatic Stay

Other courts argue that a freeze simply preserves the status quo.[13] First, some courts contend that Section 542(b) of the Bankruptcy Code authorizes the freeze. Section 542(b) generally provides that the creditor of an estate shall pay a debt owed to the debtor to the trustee, "except to the extent that such debt may be offset under Section 553 of this title. . ."[14] Since Section 542 provides "unequivocally that a creditor may refuse to turn over funds to the debtor's account if the creditor has a valid right of offset,"[15] then Section 542(b) should prevail over the more general prohibition against exercising any control over property of the estate in Section 362(a)(3).

Second, a right to setoff includes three elements: "(1) the decision to exercise the right, (2) some action which accomplishes the setoff, and (3) some record which evidences that the right of setoff has been exercised."[16] Since a freeze only includes the first element, the courts reason that a freeze is not prohibited under Section 362(a)(7), which generally provides that a setoff is a violation of the stay.[17]

A third rationale relied upon by the courts involves Section 363 of the Code. In general, Section 363(c)(2) prohibits the trustee of the debtor from using cash collateral without first obtaining the consent of the creditor or a court's authorization.[18] When a bank has a right of setoff, the debtor's deposit account is cash collateral.[19] When a bank freezes the account, the bank is prohibiting the trustee from using the cash collateral, which is precisely what the Code requires.[20] It follows that the freeze is authorized by the Code.

Finally, there is the practical matter of the "banker's dilemma."[21] After receiving notice of a debtor's bankruptcy, a banker has two options. The banker may allow the debtor to continue to use the account, in which case the debtor could continue to dissipate all the funds. In that case, the bank's right of setoff would be worthless. As the Ninth Circuit Bankruptcy Appellate Panel noted in *In re Edgins*,[22] if a creditor is required to turn over to the debtor the funds that are subject to setoff and then seek an order from the court prohibiting the debtor from dissipating the funds, this will "all too often be an attempt to lock the barn door after the horse has been stolen."[23] Alternatively, the bank could attempt to setoff the debt against the account, but this is prohibited by Section 362(a)(7). An administrative freeze, therefore, seems to be a reasonable compromise between these two undesirable options.

The banker's dilemma is further complicated by an issue discussed in a leading treatise, but not in any of the cases discussed earlier. *Collier* warns that the "interworkings of the Code provisions indicate clearly that a bank should not honor postpetition any checks drawn prepetition, particularly when it is deemed to know of the commencement of the Code case. In such an instance, it could be held liable for making payments out of the account."[24] *Collier* thus concludes that the "freeze should not be considered a violation of the stay."[25]

Authority Within the Sixth Circuit

The issue regarding whether a freeze violates the automatic stay has not been addressed by the Sixth Circuit. Further, bankruptcy courts within the Sixth Circuit have reached different conclusions. Last year, in *In re Briggs*,[26] Judge Spector determined that an administrative freeze does not violate a debtor's rights under Section 362 in a Chapter 7 case. The court relied

on the fact that the trustee acquires all the rights in the debtor's property in a Chapter 7 case. Since Section 362(a)(3) and (4) relate solely to the property of the estate, and as long as the credit union refused to release the property of the estate to the *debtor* (as opposed to the trustee), the *Briggs* court reasoned that the credit union did not violate the automatic stay. The court likewise rejected the alleged violations under Section 362(a)(7) for similar reasons. Finally, the freeze did not violate Section 362(a)(5) because a setoff right is not a lien. Considering the reasoning of the court, however, the holding of *Briggs* will be limited to Chapter 7 cases, and perhaps not even in Chapter 7 cases if the trustee complains. See also *In re Lee*,[27] which relied on the bank's ability to prohibit use of cash collateral, but which has been distinguished because the case was decided before the 1984 amendment to Section 363(a)(3).[28]

In between *Lee* and *Briggs*, two Ohio cases have taken the view that an administrative freeze does violate the automatic stay in a Chapter 11 case and a Chapter 13 case. In *In re Quality Interiors*,[29] the Bankruptcy Court for the Northern District of Ohio held in a Chapter 11 proceeding that, although an administrative freeze did not constitute a setoff, the freeze did violate the automatic stay. As evidence of the confusion surrounding this issue, the court noted that it had previously ruled on both sides of this issue. Even though the court held that the freeze violated the stay, the court did not consider sanctions because there was no evidence that the bank had actual knowledge of the bankruptcy filing when it froze the account or that it acted willfully. Likewise, in a Chapter 13 case, the court in *In re Homan*[30] determined that a freeze of the debtor's account violated Section 362(a)(3). However, earlier bankruptcy court cases in the Middle District of Tennessee have allowed a bank to freeze the debtor's accounts, provided that the bank promptly files a motion thereafter seeking relief from the stay. *In re Carpenter*;[31] *In re Ward*.[32]

BANK OPTIONS

Until the Sixth Circuit decides the issue, there is no clear answer in our district as to what a bank should do when it receives a notice of a bankruptcy filing. If a bank insists on freezing the account, it should immediately file a motion for relief from the automatic stay, or immediately seek to enjoin the debtor from dissipating the funds in the account. The court in *Homan* stated that the proper procedure is that "simultaneous" with any freeze, the bank must "seek a judicial determination of the relative rights of the parties with respect to the funds and an immediate order from the Bankruptcy Court modifying or conditioning the stay to permit the financial institution to freeze or hold the funds pending the court's resolution of the issues presented."[33] One case suggested that before dishonoring a check, a bank must file a motion with the court, and then obtain an order from the court before dishonoring a check.[34] Unfortunately, this might prove impractical. Another option is to deposit the funds with the court, as recommended by the court in *Patterson*.

CONCLUSION

Although the issue is far from settled, even within the bankruptcy courts of the Sixth Circuit, the recent trend of authority has held that a bank may not freeze an account of the debtor. Even though some courts have held a freeze to be a violation of the automatic stay, courts have generally not imposed sanctions on a bank which did freeze an account. However, with the trend of the case law appearing to hold that a freeze does violate the automatic stay, courts may be more likely to impose sanctions under Section 362(h)[35] unless the bank takes further steps to obtain court approval for its actions.

ENDNOTES

1. Sections 553 and 542 of the Bankruptcy Code generally preserve the right of setoff that exists under state law. 11 U.S.C.A. §§ 542, 553 (West 1993).
2. The Bankruptcy Code provides that an automatic stay takes effect when a petition for bankruptcy is filed. 11 U.S.C.A. § 362 (West 1993). In general, the automatic stay prohibits creditors from taking any collection efforts against the debtor.
3. Cases which have held that the administrative freeze is a violation of the automatic stay include the following: *In re Patterson*, 967 F.2d 505 (11th Cir. 1992) (Chapter 13); *United States v. Reynolds*, 764 F.2d 1004, 1007 (4th Cir. 1985) (dicta only); *United States v. Norton*, 717 F.2d 767, 773 (3rd Cir. 1983) (dicta only); *In re Flynn*, 143 B.R. 798 (Bkrtcy. D.R.I. 1992) (Chapter 7); *In re Quality Interiors, Inc.*, 127 B.R. 391 (Bkrtcy. N.D. Ohio 1991) (Chapter 11); *In re First Connecticut Small Business Inv. Co.*, 118 B.R. 179

(Bkrtcy. D. Conn. 1990) (Chapter 11); *In re Homan*, 116 B.R. 595 (Bkrtcy. S.D. Ohio 1990) (Chapter 13); *In re Wildcat Construction Co., Inc.*, 57 B.R. 981 (Bkrtcy. D. Vt.. 1986) (Chapter 11); *In re Cusanno*, 29 B.R. 810 (E.D. Pa. 1983), *vacated and remanded without opinion*, 734 F.2d 3 (3rd Cir. 1984) (Chapter 13).

Cases which have held that the administrative freeze is not a violation of the automatic stay include: *In re Edgins*, 36 B.R. 480 (9th Cir. B.A.P. 1984) (Chapter 13); *In re Briggs*, 143 B.R. 438 (Bkrtcy. E.D. Mich. 1992) (Chapter 7; no violation as to debtor only); *Citizens Bank of Maryland v. Strumpf*, 138 B.R. 792 (D. Md. 1992) (Chapter 13); *In re Craddock - Terry Shoe Corp.*, 91 B.R. 392 (Bkrtcy. W.D. Va. 1988) (Chapter 11); *In re Williams*, 61 B.R. 567 (Bkrtcy. N.D. Tex. 1986) (Chapter 11); *In re Ward*, 41 B.R. 247 (Bkrtcy. M.D. Tenn. 1984) (Chapter 7); *Matter of Lee*, 40 B.R. 123 (Bkrtcy. E.D. Mich. 1984) (Chapter 7); *Kenney's Franchise Corp. v. Central Fidelity Bank N.A*, 22 B.R. 747 (W.D. Va. 1982) (Chapter 11); *In re Carpenter*, 14 B.R. 405 (Bkrtcy. M.D. Tenn. 1981) (Chapter 7).

For a discussion of this issue, *see also* King, 4 *Collier on Bankruptcy* (15th Ed.) ¶553.15[6].

4. *In re Patterson*, 967 F.2d 505 (11th Cir. 1992). In *Patterson*, a Chapter 13 proceeding, the court held that a credit union's freeze on an account violated the automatic stay under Section 362(a)(3), (4) and (6).
5. 11 U.S.C.A. § 362(a)(3) (West 1993).
6. 967 F.2d 505 (11th Cir. 1992).
7. *Id.* at 512.
8. *See, e.g., In re Homan*, 116 B.R. 595, 602-03 (Bkrtcy. S.D. Ohio 1990).
9. *In re Patterson*, 967 F.2d 505, 510 (11th Cir. 1992); *In re Quality Interiors, Inc.*, 127 B.R. 391, 395 (Bkrtcy. N.D. Ohio 1991).
10. *In re Quality Interiors, Inc.*, 127 B.R. 391,395 (Bkrtcy. N.D. Ohio 1991).
11. *United States v. Norton*, 717 F.2d 767, 773 (3rd Cir. 1983).
12. *In re Homan*, 116 B.R. 595, 603 (Bkrtcy. S.D. Ohio 1990).
13. *In re Edgins*, 36 B.R. 480, 484 (9th Cir. B.A.P. 1984).
14. 11 U.S.C.A. § 542(b) (West 1993).
15. *In re Williams*, 61 B.R. 567, 573 (Bkrtcy. N.D. Tex. 1986).
16. *Baker v. National City Bank of Cleveland*, 511 F.2d 1016, 1018 (6th Cir. 1975).
17. Even some courts that have ruled that a freeze violates the stay have determined that the freeze does not constitute a setoff. *See, e.g., In re Quality Interiors, Inc.*, 127 B.R. 391, 393 (Bkrtcy. N.D. Ohio 1991).
18. However, this would not apply to a consumer Chapter 13 case. *See In re Homan*, 116 B.R. 595, 604 (Bkrtcy. S.D. Ohio 1990).
19. 11 U.S.C.A. § 363(a) (West 1993).
20. *In re Williams*, 61 B.R. 567, 571-72 (Bkrtcy. N.D. Tex. 1986).
21. *See Citizens Bank of Maryland v. Strumpf*, 138 B.R. 792, 793 (D. Md. 1992) (describing banker's dilemma).
22. 36 B.R. 480 (9th Cir. B.A.P. 1984).
23. 36 B.R. at 484.
24. King, 4 Collier on Bankruptcy (15th Ed.) ¶ 553.15[6]. *cf.* 11 U.S.C.A. §542(c) (West 1993) (entity that does not have notice of the commencement of a case concerning the debtor may generally transfer property of the estate, or pay a debt owing to the debtor); *Bank of Marin v England*, 385 U.S. 99 (1966) (under previous Bankruptcy Act, bank not liable for honoring a check drawn before bankruptcy but honored post-petition since bank had no notice of bankruptcy filing).
25. Id.
26. 143 B.R. 438 (Bkrtcy. E.D. Mich. 1992).
27. 143 B.R. 123 (Bkrtcy. E.D. Mich. 1984).
28. The lower court in *Patterson* distinguished pre-1984 cases by noting that Section 362(a)(3) was amended on July 10, 1984 to add the words "or to exercise control over property of the estate." The court stated that at the "trial court level, there has been increased movement toward holding such freezes to be violations of the stay either via Sections 362(a)(3) or (7) since the amendment of Section 362(a) (3)." *In re Patterson*, 125 B.R. 40, 45 (Bkrtcy. N.D. Ala. 1990), *aff'd*, 967 F.2d 505 (11th Cir. 1992).
29. 127 B.R. 391 (Bkrtcy. N.D. Ohio 1991).
30. 116 B.R. 595 (Bkrtcy. S.D. Ohio 1990).
31. 14 B.R. 405 (Bkrtcy. M.D. Tenn. 1981).
32. 41 B.R. 247 (Bkrtcy. M.D. Tenn. 1984).
33. *In re Homan*, 116 B.R. 595,605 (Bkrtcy. S.D. Ohio 1990).
34. *In re Patterson*, 967 F.2d 505, 511 (11th Cir. 1992).
35. Section 362(h) provides that an "individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages." 11 U.S.C.A. § 362(h) (West 1993).

RECENT BANKRUPTCY DECISIONS

Pioneer Investment Services Co. v. Brunswick Associates Limited Partnership, 61 U.S.L.W. 4263 (U.S. S.Ct. March 24, 1993).

In this opinion by Justice White, the Supreme Court affirmed *In re Pioneer Investment Services Co.*, 943 F.2d 673 (6th Cir. 1991), holding that an attorney's inadvertent failure to file a Chapter 11 proof of claim by the court deadline can constitute excusable neglect within the meaning of Fed. R. Bankr. P. 9006(b)(1).

The day after the debtor filed its Chapter 11 petition, the bankruptcy court mailed out a notice of meeting of creditors which stated that the bar date was August 3, 1989. The creditors received and read the notice and attended the meeting of creditors. The creditors then retained an experienced bankruptcy attorney in June, 1989 to represent them. The attorney was provided with a complete copy of the case file, including the notice of meeting of creditors. The attorney assured his client that no bar date had been set and there was no urgency in filing proofs of claim. Twenty days after the bar date the creditors filed their proofs of claim, along with a motion requesting the court to permit the late filing under Rule 9006(b)(1). The attorney claimed he was unaware of the bar date, which came at a time when he was experiencing a major disruption in his professional life caused by his withdrawal from his former law firm on July 31, 1989. Because of the disruption, the attorney did not have access to his case file until mid-August.

Rule 9006(b)(1) empowers a bankruptcy court to permit a late filing in a Chapter 11 case if the movant's failure to comply with an earlier deadline was the result of excusable neglect. According to the Court, because Congress has provided no other guideposts for determining what sorts of neglect will be considered excusable, the determination is an equitable one, taking account of all relevant circumstances surrounding the party's omission. These include the danger of prejudice to the debtor, the length of the delay and its potential impact on judicial proceedings, the reason for the delay, including whether it was within the reasonable control of the movant, and whether the movant acted in good faith. The Sixth Circuit suggested that it would be inappropriate to penalize the creditors for the omissions of their attorney. According to the Supreme Court, however, clients must be held accountable for the acts and omissions of their attorneys. In determining whether the failure to file a proof of claim before the bar date is excusable, the proper focus is upon whether the neglect of clients and their counsel is excusable.

In this case, the debtor challenged the lower court's findings regarding the creditors' good faith and the absence of any danger of prejudice to the debtor or of disruption to efficient judicial administration posed by the late filings. In assessing the attorney's culpability, the Court gave little weight to the fact that the attorney was experiencing upheaval in his law practice at the time of the bar date.

The Court did, however, consider significant that the notice of the bar date provided by the bankruptcy court was outside the ordinary course in bankruptcy cases. Ordinarily, the bar date in a bankruptcy case should be prominently announced and accompanied by an explanation of its significance. The peculiar and inconspicuous placement of the bar date in a notice regarding a creditors' meeting, without any indication of the significance of the bar date, left a dramatic ambiguity in the notification. This was not to say that creditors' counsel was not remiss in failing to apprehend the notice. According to the Court, were there any evidence of prejudice to the debtor or to judicial administration, or any indication at all of bad faith, the Court could not say that the bankruptcy court abused its discretion in declining to find the neglect to be excusable. In the absence of such a showing, however, the Court concluded that the unusual form of notice required a finding that the neglect of creditors' counsel was, under all the circumstances, excusable.

Justice O'Connor, in her dissent, which was joined by Justices Scalia, Souter and Thomas, stated that the majority's equitable balancing approach to excusable neglect is contrary to the language of Rule 9006(b) and inconsistent with sensible notions of judicial economy. According to Justice O'Connor, its indeterminacy not only renders consistent application unlikely but also invites unproductive recourse to appeal. A bankruptcy debtor can ill afford to waste resources on litigation; every dollar spent on lawyers is a dollar creditors will never see. Application of Rule 9006(b)(1)'s plain

language is straightforward. First, we must examine the failure to act itself and ask if it resulted from excusable neglect. If it did, then the lower court may, in its discretion, permit untimely action in accord with the equities. But if the failure did not result from excusable neglect, there is no reason to consider the effects of the failure.

U.S. v. McDermott, 61 U.S.L.W. 4282 (U.S.S.Ct. March 24, 1993).

This Supreme Court decision, authored by Justice Scalia, involves the issue of the priority of a federal tax lien over a private creditor's judgment lien as to a delinquent taxpayer's after-acquired real property.

In December, 1986, the IRS assessed the taxpayers for unpaid federal taxes. Upon that assessment, 26 U.S.C §§6321 and 6322 created a lien in favor of the United States on all the taxpayers' real and personal property, including after-acquired property. Pursuant to 26 U.S.C. §6323(a), however, that lien could "not be valid as against any . . . judgment lien creditor until notice thereof . . . has been filed." The IRS did not file the lien in the County Recorder's Office until September, 1987. Before that occurred, the bank in July, 1987 docketed with the County Clerk a state court judgment against the taxpayers. Under Utah law, that created a judgment lien on all of the taxpayers' real property in the County owned at the time or thereafter acquired during the existence of the lien. In September, 1987, the taxpayers acquired real property in the County. The taxpayers then brought an interpleader action to establish which lien was entitled to priority.

The Court held that a federal tax lien filed before a delinquent taxpayer acquires real property must be given priority over a private creditor's previously filed judgment lien. Absent a contrary provision, priority for purposes of federal law is governed by the common law principle that first in time is the first in right. A state lien that competes with a federal lien is deemed to be in existence for "first in time" purposes only when it has been perfected in the sense that the identity of the lienor, the property subject to the lien, and the amount of the lien are established. The bank's lien did not actually attach to the property at issue until the taxpayer acquired rights in that property. Since that occurred after filing of the federal tax lien, the state lien was not first in time. However, like the state lien, the federal tax lien did not attach until the same instant the state lien attached -- when the taxpayers acquired the property. Under 26 U.S.C. §6323(a), however, "the filing of notice renders the federal tax lien extant for first in time priority purposes regardless of whether it has yet attached to identifiable property." Accordingly, the federal tax lien was given priority over the state judgment lien.

Justice Thomas, joined by Justices Stevens and O'Connor, dissented. He thought that the bank's antecedent judgment lien had already acquired sufficient substance and had become so perfected with respect to the after-acquired real property as to defeat the later filed federal tax lien.

Reiter v. Cooper, 61 U.S.L.W. 4232 (U.S.S.Ct. March 8, 1993).

This Supreme Court opinion, authored by Justice Scalia, involves a Chapter 7 trustee's initiation of adversary proceedings to recover shipping charges.

The Interstate Commerce Act ("Act") requires motor common carriers to charge the tariff rates that they file with the Interstate Commerce Commission ("ICC"). Under the Act, tariff rates are required to be reasonable and shippers have a cause of action against carriers for damages in the amount of the difference between the tariff rate and the rate the ICC determines is reasonable. Pre-petition, certain shippers tendered shipments to the debtor, a motor carrier, at negotiated rates that were lower than the tariff rates on file with the ICC. The Chapter 7 trustee filed adversary proceedings against the shippers to recover the difference between the negotiated rates and the tariff rates. The shippers claimed that the tariff rates were unlawful because they were unreasonably high.

The Court held that payment of the tariff rate was not a prerequisite to litigating the rate reasonableness issue. In addition, the shippers were not required to initially present their unreasonable rate claims to the ICC, rather than to a court.

In re Davis, Case No. 92-5081 (6th Cir. March 24, 1993).

In this opinion, the Sixth Circuit held that a secured creditor was not deprived of the protection of

§1322(b)(2) merely because language in the deed of trust required hazard insurance.

Section 1322(b)(2) precludes a debtor from modifying the rights of any secured creditor who holds a claim secured only by a security interest in real property that is the debtor's principal residence. The court rejected the argument that, due to the insurance, the creditor's claim was secured by more than the debtor's principal residence. To interpret "additional security" to include mandatory hazard insurance would defeat the purpose of §1322(b)(2), which is to protect creditors. Accordingly, the Sixth Circuit held that a requirement of hazard insurance with the creditor designated as beneficiary will not ordinarily take a creditor outside the protection of §1322(b)(2), even when the creditor retains physical possession of the policy.

In addition, the creditor was not deprived of the protection of §1322(b)(2) because the deed of trust granted to the creditor an interest in rents, royalties, profits and fixtures. According to the Sixth Circuit, these benefits are merely incidental to an interest in real property and the creditor's interest in the incidental benefits did not constitute additional security for purposes of §1322(b)(2).

Lastly, the court found that the protection of §1322(b)(2) is available to a holder of a short-term, non-purchase money loan on a principal residence, such as a finance company specializing in short-term financing.

Easley v. Pettibone Michigan Corporation, Case No. 92-1382 (6th Cir. April 8, 1993).

In this decision, the Sixth Circuit addressed the issue of whether plaintiffs' filing of their products liability suit against defendants during the pendency of the automatic stay in the defendants' bankruptcy proceeding was sufficient commencement of the action for purposes of complying with the applicable statute of limitations.

In July, 1988, plaintiffs filed their product liability complaint five days before the three-year Michigan statute of limitation for products liability actions ran. However, the automatic stay was in effect when the complaint was filed. In December, 1988, the debtors' Chapter 11 plan was confirmed and the stay was dissolved.

The July, 1988 complaint violated the stay. The Sixth Circuit held that actions taken in violation of the stay are invalid and voidable and shall be voided absent limited equitable circumstances. Only where the debtor unreasonably withholds notice of the stay and the creditor would be prejudiced if the debtor is able to raise the stay as a defense, or where the debtor is attempting to use the stay unfairly as a shield to avoid an unfavorable result, will the protections of § 362 be unavailable. Here, the defendant did not behave unreasonably. As soon as it was made aware of the suit, it notified plaintiffs that they violated the automatic stay. Although plaintiffs were prejudiced because they lost their products liability claim, this was because they failed to refile their action within the thirty-day grace period afforded by § 108(c). Accordingly, the complaint was voided.

In re Atron Inc. of Michigan, Case No. 1:93-CV-133 (W.D. Mich. March 9, 1993).

In this decision, Judge Bell denied the defendant's motion for leave to appeal the bankruptcy court's remand order.

Defendant was originally sued in Ionia County Circuit Court. He then removed the case to bankruptcy court. The bankruptcy court then remanded, sua sponte, the action back to Ionia County Circuit Court.

The district court held that the bankruptcy court had authority to remand the matter to state court under 28 U.S.C. §1452(b). The district court held that the bankruptcy court properly determined that the case involved only state law claims that appeared to relate to non-core claims to which neither counsel would agree to the bankruptcy court's entry of final orders. The bankruptcy court also properly concluded that the better forum to litigate the state law claims was state court.

In re Rochkind, Case No. 92-CV-71437-DT (E.D. Mich. January 22, 1993).

In this case, Judge Rosen affirmed the bankruptcy court's order granting relief from order denying motion to lift stay and order granting motion to lift stay.

The debtor filed a Chapter 7 petition to stay a mortgage foreclosure. The debtor's husband and the creditor were law partners before the creditor became a

judge. The creditor filed a motion to lift the stay. The debtor defended on the basis that the note and mortgage were executed under duress, since the creditor, when he was a judge, threatened to use his judicial office against the debtor's husband if the debt was not paid. The issue was whether the threat was made before the note and mortgage were executed.

At first, the bankruptcy court found that the threat was made before the note and mortgage were executed. Therefore, the bankruptcy court denied the motion to lift the stay because the note and mortgage were signed under duress. However, newly discovered credible evidence was later presented which indicated that the threat occurred after the note and mortgage were executed. Therefore, the bankruptcy court reversed its prior order and lifted the stay.

The district court found that the bankruptcy court did not abuse its discretion in entering its order granting relief from the order denying motion to lift stay and that the bankruptcy court was not clearly erroneous when it granted the motion to lift the automatic stay.

In re Kuriakuz, Case No. 92-CV-73636-DT (E.D. Mich. December 23, 1992).

In this opinion, authored by Judge Hackett, the district court affirmed the bankruptcy court's decision that a debt which was determined to be nondischargeable in Chapter 7 could be discharged in a subsequent Chapter 13 case. The district court also held that the bankruptcy court's finding that the debtor had regular income and was eligible for Chapter 13 relief was not clearly erroneous. However, the district court remanded the case to the bankruptcy court for specific findings of fact regarding whether the debtor proposed his plan in good faith in accordance with §1325(a)(3).

In re Zimmerman, Case No. SG 91-86620 (Bankr. W.D. Mich. March 19, 1993); ***In re Neuman***, Case No. SG 92-01892 (Bankr. W.D. Mich. March 19, 1993).

In this matter, Judge Howard, Judge Gregg and Judge Stevenson entered an Order Consolidating Cases, Setting Briefing Schedule, Ordering Hearing En Banc and Allowing Filing of Briefs by Amicus Curiae. In these Chapter 13 cases, the debtors objected to claims of taxing authorities because the claims were filed after the bar date established pursuant to Fed. R. Bankr. P. 3002(c). Counsel for the debtors were ordered to brief the following issues:

1. Under 11 U.S.C. §502(b), may a creditor's claim be disallowed for the sole reason that it is filed after the bar date imposed by Fed. R. Bankr. P. 3002(c)?

2. Assuming arguendo that under 11 U.S.C. §502(b) a creditor's claim may not be disallowed for the sole reason that it is filed after the bar date, what measures should be taken either by the court, by debtor's counsel, or by the chapter 13 trustee to provide for the administration of chapter 13 estates in which late claims are filed?

A hearing on these issues will take place on June 7, 1993 before the Bankruptcy Court sitting en banc. Interested parties are invited to file amicus curiae briefs, not to exceed 10 pages, addressing either of the two issues, provided that all such briefs shall be filed along with 7 copies and served upon the parties listed in the order before 4:30 p.m. on May 20, 1993.

In re Mother Hubbard, Inc., Case No. GG 91-80981 (Bankr. W.D. Mich. March 5, 1993).

This opinion by Judge Gregg involves the issues of whether the sole shareholder of a Chapter 11 debtor should be allowed to file an untimely unsecured claim and whether an unsecured creditor should be allowed to file a competing Chapter 11 plan.

The debtor's president and sole shareholder did not file a proof of claim before the claims bar date despite his knowledge of it. He formally filed a claim eight months after the bar date. The debtor's president argued that an informal proof of claim had been filed and that the untimely filed proof of claim should be considered an amendment. The court rejected this argument. A written document filed with the bankruptcy court which contains a demand on the estate or otherwise expresses an intent to hold the debtor liable for an alleged debt will serve as an informal proof of claim. Here, the documents did not show an intent by the debtor's president individually to hold the estate liable for his unsecured claim. In addition, the documents could not be considered as a demand for payment.

The court also rejected the argument that the court should allow the late claim under the excusable neglect theory. The court found that the major factor applicable from the Sixth Circuit's decision in Pioneer Investment Services Co. [see the summary of the Supreme Court's decision above] was whether the delay in filing the proof of claim was beyond the reasonable control of the debtor's president. According to the court, the debtor's president made a conscious decision not to file a proof of claim, assertedly believing a waiver of his unfiled claim would be the best alternative for the debtor's reorganization. The court found the delay in filing the claim was not beyond the debtor's president's reasonable control. Although he made a bad decision in failing to timely file his claim, such a conscious decision was not excusable and the decision was not neglect -- it was a voluntary omission within his sole control.

The court next addressed whether a creditor should be permitted to file a competing plan. If a debtor fails to produce or confirm a plan within the time parameters of §1121, Fed. R. Bankr. P. 3016(a) contemplates that other parties in interest may file competing plans. Pursuant to §1121(c)(3), a creditor may file a plan if the debtor has not filed a plan which has been accepted by *all impaired classes* within the exclusivity period. Because the exclusivity period expired and the debtor's first plan was not accepted by all impaired classes, §1123(c)(3) authorized the creditor to file a competing plan.

Lastly, the court held that a bankruptcy judge may sua sponte raise the issue whether a Chapter 11 trustee should be appointed. However, it is improper to sua sponte raise the issue unless persuasive evidence comes to the court's attention on the record which may lead to a conclusion that cause exists for a trustee's appointment or an abuse of process is occurring. Because the creditors' committee and the largest creditor had sufficient incentives to monitor the debtor's business activities, the court declined to exercise its power to sua sponte hold a hearing regarding the possible appointment of a Chapter 11 trustee.

In re Auto Specialties Manufacturing Co., Case No. SK 88-03095 (Bankr. W.D. Mich. March 31, 1993).

In this opinion, Judge Stevenson granted the motions of the defendant bank and the individual defendant for summary judgment in regard to the Chapter 7 trustee's preference actions.

The preference actions arose out of a modification to an irrevocable letter of credit in which the issuer was the bank, the customer was the debtor and the beneficiary was the defendant. The letter of credit was originally issued as part of a bonus negotiated by the defendant in connection with his employment agreement with the debtor. The letter of credit was amended so that the defendant could immediately draw $300,000.00 without satisfying the original conditions.

The transfers were the modification of the letter of credit and the payment to the bank pursuant to the modification. The issue was whether the trustee raised an issue of fact as to the §547(b)(5) requirement that the defendant received more as a result of the transfer than he would have had the transfer not been made and the case been filed under Chapter 7. In the context of this case, the issue was whether the defendant would have been entitled to draw at lease $300,000.00 on the letter of credit on or before its expiration date of June 1, 1989 had the letter of credit not been modified and had the debtor filed a Chapter 7 petition rather than a Chapter 11 petition on October 3, 1988.

The court found that under the "independence principle" the defendant's performance of the underlying employment contract was not a condition of payment under the letter of credit. The defendant was entitled to draw on the letter of credit regardless of any breach by the defendant of the underlying employment agreement. In short, the defendant did not receive a preference because under §547(b)(5) the defendant did not improve his position. Since the trustee had no claim against the defendant, he had none against the bank either.

In re Hall, Case No. GK 91-81542 (Bankr. W.D. Mich. February 18, 1993).

This opinion by Judge Gregg involves the issues of (1) whether a pension plan maintained by and benefitting only a sole shareholder and his spouse is property of the estate pursuant to § 541(c)(2); (2) if the pension plan is property of the estate, whether the pension plan may be exempted pursuant to § 522(d)(10)(E); and (3) may an individual retirement plan be exempt from property of the estate pursuant to § 522(d)(10)(E).

The court first held that the pension plan was property of the estate pursuant to § 541(c)(2). Pursuant to Patterson v. Shumate, 112 S.Ct. 2242 (1992), ERISA-qualified retirement plans are excluded from property of the estate. According to the bankruptcy court, an "ERISA-qualified" plan is (1) tax qualified under 26 U.S.C. § 401(a); (2) subject to ERISA; and (3) includes an anti-alienation provision. If even one requirement is not satisfied, a plan is not ERISA-qualified. For a plan to be subject to ERISA, it must exclusively provide benefits to employees. Here, the debtor was the president and sole shareholder of his former company when the pension plan was executed. The debtor and his wife were the only eligible participants. Moreover, the debtor and his spouse were the sole and exclusive beneficiaries of the pension plan. Therefore, the debtor and his spouse were considered employers, not employees, for ERISA purposes. The pension plan violated the ERISA requirement that plan assets must be used for the exclusive benefit of employees. The pension plan was not ERISA-qualified because it was not subject to ERISA. Therefore, the pension plan was property of the estate because § 541(c)(2) was not satisfied.

The court next held that the pension plan was not exempted from property of the estate pursuant to § 522(d)(10)(E)(i) -(iii). Section 522(d)(10)(E) exempts from property of the estate:

> (E) a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless--
>
> (i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose;
>
> (ii) such payment is on account of age or length of service; and
>
> (iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), 408, or 409 of the Internal Revenue Code . . . .

The court found that the pension plan was established under the auspices of an insider, so § 522(d)(10)(E)(i) was satisfied. In addition, § 522(d)(10)(E)(ii) was satisfied because any payments were based on account of age or length of service. Section 522(d)(10)(E)(iii) was also satisfied since the minimum participation rule of 26 U.S.C. § 401(a)(26) was violated. The debtor violated this tax provision because the pension plan did not benefit 40% or more of all employees of the debtor's former company. Since the three requirements of § 522(d)(10)(E)(i)-(iii) were proven, the debtor's interest in the pension plan was not exempt.

However, the court held that the debtor's separate individual retirement plan was exempt under § 522(d)(10)(E) to the extent reasonably necessary for support of the debtor. [Thereby coming to a conclusion contrary to that reached in In re Moss, 143 B.R. 465, 466-67 (Bankr. W.D. Mich. 1992)]. After considering the debtor's age, health, ability to earn income, actual current income, actual expenses, and limited ability to save for retirement, the court found that the individual retirement plan payment totalling approximately $14,000 was reasonably necessary for the debtor's future support.

FROM THE OFFICE OF THE UNITED STATES TRUSTEE REGARDING "SUBSTANTIAL ABUSE" ISSUES

(Editor's Note: Assistant U.S. Trustee Daniel J. Casamatta has forwarded the following information about the position of his office on the issue of "substantial abuse" under §707(b) of the Bankruptcy Code.)

The United States Trustee filed a Motion to Dismiss under 11 U.S.C. Section 707(b) in the Chapter 7 proceeding of In re John A. Lanum, Case No. SL 92-85591 (J. Stevenson). The United States Trustee alleged that the Debtor's Chapter 7 filing evidenced a substantial abuse of the bankruptcy process. The Chapter 7 Trustee appointed to this case was Michael Puerner. After the motion was filed but prior to the hearing, the Debtor, a single man with no legal dependents, filed an amended budget which disclosed that he had the following monthly expenses: food in the amount of $438.00; clothing in the amount of $132.00; transportation in the

amount of $357.00; and recreation in the amount of $440.00.

At the April 13, 1993 hearing on the matter, Chapter 13 Trustee Brett Rodgers, acting as an expert witness for the United States Trustee, testified that these four expense items were exceedingly high. He further testified that if the expenses were appropriately reduced, the Debtor could fund at least a 65% Chapter 13 plan over three years. The Court also commented on the record that the Debtor's stated expenses were high for a debtor seeking Chapter 7 relief.

After the hearing but prior to the Court's ruling, the Debtor voluntarily agreed to dismiss his Chapter 7 proceeding.

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the period from January 1, 1993 through March 31, 1993. These filings are compared to those made during the same period one year ago and two years ago.

	1/1/93-3/31/93	1/1/92-3/31/92	1/1/91-3/31/91
Chapter 7	1,183	1,508	1,335
Chapter 11	32	28	47
Chapter 12	8	5	3
Chapter 13	366	439	472
	1,589	1,980	1,857

REMINDER TO MAKE 1993 SEMINAR HOTEL RESERVATIONS

The 1993 Seminar is being held on Mackinaw Island on July 29-31, which is the height of the season. Therefore, it is essential that hotel reservations be made on or before June 14, 1993. Interested persons can contact the Seminar headquarters, the Lakeview Hotel, at (906) 847-3384 and talk to Rick Peterson, hotel manager. Overflow rooms are available at the Murray and Chippewa Hotels. Alternatively, members can make direct arrangements for reservations at the Grand Hotel.

STEERING COMMITTEE MEETING MINUTES

A meeting of the Steering Committee of the Bankruptcy Section of the Federal Bar Association for the Western District of Michigan was held on April 23, 1993 at the Peninsular Club. Present: Bob Sawdey, John Grant (for Denise Twinney), Bonnie Schaub (for Tim Hillegonds), Pat Mears, Brett Rodgers, Bob Wright, Tom Schouten, Jim Engbers and Steve Rayman. Also present were Judge Gregg, Mark VanAllsburg, Dan Casamatta, and Doug Lutz (guest of Pat Mears).

1. **1993 Seminar**. Steve Rayman discussed the topics and speakers that have been selected for the 1993 seminar at the Lakeview Hotel on Mackinaw Island on July 29 - 31, 1993. Steve noted that it was very difficult to narrow the selection down, considering the high quality of practitioners available within the district to speak at such programs. A flyer for the seminar will be prepared shortly and will either be included with the April, 1993 Bankruptcy Law Newsletter or will be mailed separately to members.

Steve Rayman raised the question of reimbursement of expenses to non-members of the Federal Bar Association who are invited to speak at our seminars. A motion was made and seconded that the Federal Bar

Association reimburse out-of-pocket expenses of non-members who are invited to speak at the 1993 Seminar. After discussion, the motion was passed.

2. **Recreational Arrangements for 1993 Seminar**. John Grant, on behalf of Denise Twinney, outlined the recreational activities for the 1993 Seminar. These include a welcoming cocktail party on July 29, a golf tournament, and a sunset cruise on July 30. Details will be provided in the seminar flyer.

3. **Mailing of Newsletter to Trustees**. Tom Sarb reported that he had received a number of inquiries from Trustees who requested that they continue to receive the Bankruptcy Law Newsletter published by the FBA Bankruptcy Section. A motion was made and seconded that the Bankruptcy Section continue to mail the Bankruptcy Law Newsletter to all Chapter 7 and Chapter 13 Trustees in the Western District free of charge. After discussion, the motion was passed.

4. **Portrait of Judge Nims**. Brett Rodgers discussed the hanging ceremony for Judge Nims' portrait in his former courtroom. Tom Sarb, Mark VanAllsburg, and Brett Rodgers will work to coordinatethe portrait hanging and announcements of the event.

EDITOR'S NOTEBOOK

The monthly recent case summaries that appear in the Newsletter are an essential feature of the Newsletter. Another factor that distinguishes the Newsletter are the fine lead articles on selected topics of law, such as this month's article by Tim Hillegonds and Gordon Toering entitled "Freezing the Debtor's Bank Account and the Automatic Stay." We are looking for articles for the August, September, and October, 1993 issues. If you would be interested in submitting an article for publication in the Newsletter, please contact Tom Sarb at (616) 459-8311. Thank you in advance for helping to make the Newsletter a valuable tool for the bankruptcy practitioner in this district.

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