11 USC §362(a)(3)
11 USC §542(b)
11 USC §553
11 USC §1141

Northwest Marine Iron Works v. USA Dept of Navy Civ No. 90-223-MA
Adv. No. 88-0133-S

In re Northwest Marine Iron Works Case No. 386-05815-S11

5/24/90 Marsh, J. affirming Judge Sullivan's oral ruling

The debtor performed work on ships for the Navy. The Navy had overpaid the debtor $735,000 on one account, but held a retainage account of $945,000 on another. After the debtor demanded the retainage on the latter contract, the Navy placed $735,000 in a suspense account to cover the overpayment, and paid the remaining $210,000 to the debtor.

The navy did not violate the stay by placing the funds in a suspense account pending a determination of it's setoff claim. The debts were mutual, and the Navy's setoff claim was a secured claim. Confirmation of the chapter 11 plan did not discharge the Navy's secured claim or render the setoff account free and clear of the Navy's claim, because the plan did not acknowledge or make explicit provision for the treatment of the claim or interest. The claim was not discharged, and the Navy was entitled to keep the funds.

FILED

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

NORTHWEST MARINE IRON WORKS, an Oregon corporation, Plaintiff-Appellant, v. UNITED STATES OF AMERICA, DEPARTMENT OF NAVY, Defendant-Appellee.	Civil No. 90-223-MA OPINION
In re NORTHWEST MARINE IRON WORKS, an Oregon corporation, Debtor.	Case No. 386-05815-S11 Adversary Proceeding No. 88-0133-S

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MARSH, Judge.

This is an appeal from the bankruptcy court's decision upholding the United States Department of Navy's ("Navy") right to exercise a setoff against a debt the Navy owed to Northwest Marine Iron Works ("Northwest Marine"), the debtor. Two issues are raised on appeal: (1) whether the Navy violated the automatic stay in bankruptcy by exercising control over property of the estate; and (2) whether confirmation of Northwest Marine's reorganization plan terminated the Navy's right to a setoff. For the reasons set forth below, I affirm the bankruptcy court's decision.

BACKGROUND

Northwest Marine operates a ship repair yard on Swan Island in Portland, Oregon. In 1982, the Navy awarded Northwest Marine a contract for the overhaul of the USS WILSON. In 1985, the Navy awarded Northwest Marine a contract for the overhaul of the USS CUSHING. While the Navy overpaid Northwest Marine $734,978 for the overhaul of the USS WILSON, the Navy retained $945,196 of the money owing to Northwest Marine on the USS CUSHING overhaul. The parties do not dispute the amounts owed on these contracts.

On October 29, 1986, Northwest Marine filed for bankruptcy under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101 et seq.

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On November 7, 1986, Northwest Marine requested payment of the money retained by the Navy on the USS CUSHING overhaul contract. On January 26, 1987, the Navy filed a proof of claim in the bankruptcy court for the $734,978 overpaid on the USS WILSON contract. On March 4, 1987, the Navy placed $734,978 of the balance due on the USS CUSHING contract in a suspense account to cover the Wilson overpayment and paid the remainder of the USS CUSHING contract balance to Northwest Marine. While the bankruptcy court ultimately allowed the Navy's claim for a setoff based on the Navy's overpayment on the USS WILSON contract[1], the Navy did not seek leave of the bankruptcy court or otherwise adjudicate its right to a setoff prior to depositing the $734,978 in the suspense account.

On March 20, 1987, the reorganization plan for Northwest Marine was confirmed. While the plan provides for unsecured creditors in general, the plan makes no reference to the $734,978 setoff or to the Navy as a secured creditor.

On March 18, 1988, Northwest Marine filed a complaint for turnover and payment of the $734,978 retained by the Navy in the suspense account. Northwest Marine alleged that the Navy's offset

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[1] On December 3, 1987, Northwest Marine filed an objection to the Navy's setoff claim. On December 24, 1987, the Navy moved to dismiss this objection. While the record on appeal shows that a hearing on this matter was scheduled for February 8, 1988, the record does not disclose the actual date on which this objection was rejected by the bankruptcy court. In Judge Sullivan's oral ruling on the parties' summary judgment motions, he states that the Navy's claim was perfected when the court dealt with the setoff claim "earlier in the year." Under 11 U.S.C. § 502(a), a setoff is deemed allowed until the debtor objects.

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of the amount owed under the USS CUSHING contract against the amount owed under the USS WILSON contract was invalid because the Navy did not obtain relief from the automatic stay in bankruptcy before exercising its right to a setoff.

On March 10, 1989, the bankruptcy court granted the Navy's motion for summary judgment and denied Northwest Marine's motion for summary judgment on the Navy's exercise of the $734,978 setoff. The court held that: (1) the Navy did not violate the automatic stay in bankruptcy because the debts arising from the overpayment on the USS WILSON contract and from underpayment on the USS CUSHING contract were mutual debts, and the Navy was justified in setting up an administrative freeze on the funds; (2) the USS WILSON debt was not waived by discharge; (3) the setoff was a security interest which survived discharge; (4) the confirmation process did not void the setoff; and (5) the Navy preserved its right to seek a determination of the setoff by filing a claim and asserting the right to a setoff.

On appeal, Northwest Marine argues that (1) the Navy violated the automatic stay by exercising control over the property of the estate and (2) the confirmation of the reorganization plan terminated the Navy's right to assert a setoff.

STANDARDS

The bankruptcy court decided both of the issues which are the subject matter of this appeal as a matter of law. Accordingly, the bankruptcy court's decision is subject to de novo review. Ragsdale v. Haller, 780 F.2d 794, 795 (9th Cir. 1986).

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DISCUSSION

Northwest Marine argues that the automatic stay prohibited the Navy from setting off the USS CUSHING retainage against the USS WILSON overpayment. Consequently, Northwest Marine contends that the Navy exercised control over the property of the estate in violation of 11 U.S.C. § 362(a)(3) by placing the setoff funds in a suspense account,. In support of this argument, Northwest Marine relies on two cases: In re Cusanno, 17 B.R. 879 (Bankr. E.D.Pa. 1982), and In re Newport Offshore, Ltd., 78 Bankr. 383 (Bankr. D.R.I. 1987).

In Cusanno, the bankruptcy court held that a bank violated the automatic stay by freezing a debtor's checking account as a setoff against outstanding loans. In Newport Offshore, the court held that the Army violated the automatic stay by asking the Navy to withhold funds due on another account. However, unlike this case, in Newport Offshore, the Army's setoff claim had been disallowed and the Army was specifically enjoined from attempting a setoff.

The reasoning in Cusanno was rejected by the Ninth Circuit bankruptcy court in In re Edgins, 36 Bankr. 480 (Bankr. 9th Cir. 1987). In Edgins, the court held that an "administrative freeze" placed on the debtor's banking account was not an attempt to obtain possession of the property of the debtor's estate nor to determine ownership of the funds in violation of the automatic stay in bankruptcy. Id. at 484. Rather, the court held that an administrative freeze merely gives notice to the debtor that an

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interest is claimed in the funds and prevents dissipation of that claimed interest pending the court's determination of ownership. Id.

Edgins reached the conclusion that an administrative freeze does not violate the automatic stay based on the language of 11 U.S.C. § 542(b). Section 542(b) provides that "an entity that owes a debt that is property of the estate . . . shall pay such debt to . . . the trustee, except to the extent that such debt may be an offset under section 553 of this title against a claim against the debtor." Edgins holds that under § 542(b), a creditor may defer payment pending a hearing on the right to a setoff and that this deferral of payment does not violate the automatic stay because the creditor is not exercising a setoff. Id. at 483. This is so because the creditor cannot use the frozen funds to cancel the mutual debt until the court approves the setoff. Id. The court stated:

> The shield of 11 U.S.C. Section 362, which is procedural and vests no intrinsic interest in property to the estate, should not be used as a sword to divest other parties of legitimate interests in property particularly where the debtor has the knowledge and means to bring whatever claim he [or she] may have for use of the funds on for prompt hearing.

Id. at 484.

I reject Northwest Marine's argument that Edgins was overruled by Congress in 1984 when it amended 11 U.S.C. § 362(a)(3) to add the prohibition against exercising "control over property of the estate" to the already existing prohibition against obtaining "possession of property of the estate." The amendment to

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§ 362(a)(3) merely restates the problem addressed in Edgins - whether the right to protect a setoff by deferring payment under § 542(b) is to be interpreted as prohibited under § 362(a)(3).

The Bankruptcy Court was correct in findng that the Navy's overpayment and underpayment on the overhaul contracts were mutual debts and that the the suspense account was equivalent to the administrative freeze approved in Edgins. The Navy's administrative freeze did not amount to an exercise of control in violation of the automatic stay but rather was a payment deferral until the Navy's setoff claim could be adjudicated.

Northwest Marine also argues that the Navy is not entitled to the $734,978 because the Navy failed to exercised its right to setoff prior to confirmation of the reorganization plan. Northwest Marine contends that pursuant to 11 U.S.C. § 1141, all creditors' claims against Northwest Marine were discharged by the plan's confirmation including the Navy's setoff claim. I disagree. The Navy's setoff is a secured claim which was not discharged by the confirmation plan.

A setoff is a secured claim by operation of § 553(a). See Edgins, 36 Bankr. at 482-83. Section 553(a) provides that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor [arising more than 90 days before the filing of a bankruptcy petition] . . . against a claim of such creditor against the debtor" that also arose more than 90 days before the filing of the petition.

Confirmation of a reorganization plan is governed by 11 U.S.C.

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§ 1141 and by the terms of the plan itself. Section 1141 provides that after a reorganization plan is confirmed, all property "dealt with by the plan" is free and clear of creditors' claims and interests and the debtor is discharged from any debt dealt with by the plan arising before the date of confirmation. For a claim or interest to be dealt with by the plan, the plan must acknowledge, and make explicit provision for the treatment of, the claim or interest. In re Work, 58 Bankr. 868, 871 (Bankr. D.Or. 1986), citing In re Gregory, 19 Bankr. 668 (Bankr. 9th Cir. 1982).

The Northwest Marine plan does not discharge the Navy's setoff claim because the plan does not acknowledge this claim or make explicit provision for it. Indeed, while the plan provides a five percent debenture for unsecured claims, there is no provision dealing with unnamed secured creditors. Because the setoff is not "dealt with" by the plan, the funds in the suspense account are not free and clear of all claims and interests of creditors. Thus, the Navy's secured claim under § 553(a) survived the confirmation of the reorganization plan. See also In re Commercial W. Fin. Corp., 761 F.2d 1329, 1336-37 (9th Cir. 1985)(holding that based on due process considerations, it is inappropriate to resolve secured claims against the estate by discharging them through confirmation instead of through the adversary claims procedure in bankruptcy).

With respect to the issue of whether the plan allowed the bankruptcy court to grant the Navy's setoff claim after confirmation, Article XI of the Northwest Marine plan provides

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that the bankruptcy court "shall retain jurisdiction of the Chapter 11 case . . . to determine allowance or disallowance of claims and interest, [and] . . for curing any omission . . . in the Plan." I find that Article XI contemplates post-confirmation determinations of secured claims and interests by the bankruptcy court such as the bankruptcy court's allowance of the Navy's setoff claim at issue in this appeal.[2]

CONCLUSION

For the reasons set forth above, the bankruptcy court's decision allowing the Navy's setoff claim is affirmed.

DATED this 23 day of May, 1990.

Malcolm F. Marsh
United States District Judge

[2] Because I find that the Navy's setoff claim is a secured claim which survived confirmation of the plan, I need not reach the issue of whether the setoff also constitutes a secured lien.

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IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

NORTHWEST MARINE IRON WORKS, an Oregon corporation, Plaintiff-Appellant, v. UNITED STATES OF AMERICA, DEPARTMENT OF NAVY, Defendant-Appellee.	Civil No. 90-223-MA ORDER
In re NORTHWEST MARINE IRON WORKS, an Oregon corporation, Debtor.	Case No. 386-05815-S11 Adversary Proceeding No. 88-0133-S

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For the reasons set forth in my opinion filed this date, the bankruptcy court's decision allowing the Navy's setoff claim is affirmed.

IT IS SO ORDERED.

DATED this 23 day of May, 1990.

Malcolm F. Marsh
United States District Judge

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CLERK, U.S. DISTRICT COURT
DISTRICT OF OREGON
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IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

NORTHWEST MARINE IRON WORKS, an Oregon corporation, Plaintiff-Appellant, v. UNITED STATES OF AMERICA, DEPARTMENT OF NAVY, Defendant-Appellee.	Civil No. 90-223-MA JUDGMENT
In re NORTHWEST MARINE IRON WORKS, an Oregon corporation, Debtor.	Case No. 386-05815-S11 Adversary Proceeding No. 88-0133-S

Based on the record,

IT IS ORDERED AND ADJUDGED the decision of the Bankruptcy Court is AFFIRMED.

DATED: this 24 day of May, 1990.

Malcolm F. Marsh
United States District Judge

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