

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.

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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

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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5 MARSH, Judge.

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

15 BACKGROUND

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

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

26 2 - OPINION

1 On November 7, 1986, Northwest Marine requested payment of the
2 money retained by the Navy on the USS CUSHING overhaul contract.
3 On January 26, 1987, the Navy filed a proof of claim in the
4 bankruptcy court for the \$734,978 overpaid on the USS WILSON
5 contract. On March 4, 1987, the Navy placed \$734,978 of the
6 balance due on the USS CUSHING contract in a suspense account to
7 cover the Wilson overpayment and paid the remainder of the USS
8 CUSHING contract balance to Northwest Marine. While the
9 bankruptcy court ultimately allowed the Navy's claim for a setoff
10 based on the Navy's overpayment on the USS WILSON contract¹, the
11 Navy did not seek leave of the bankruptcy court or otherwise
12 adjudicate its right to a setoff prior to depositing the \$734,978
13 in the suspense account.

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

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

21 ¹ On December 3, 1987, Northwest Marine filed an objection
22 to the Navy's setoff claim. On December 24, 1987, the Navy moved
23 to dismiss this objection. While the record on appeal shows that
24 a hearing on this matter was scheduled for February 8, 1988, the
25 record does not disclose the actual date on which this objection
26 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.

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

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

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

22 STANDARDS

23 The bankruptcy court decided both of the issues which are the
24 subject matter of this appeal as a matter of law. Accordingly,
25 the bankruptcy court's decision is subject to de novo review.
26 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

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

3 Id.

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

16 The court stated:

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

24 Id. at 484.

25 I reject Northwest Marine's argument that Edgins was overruled
26 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

6 - OPINION

1 § 362(a)(3) merely restates the problem addressed in Edgins -
2 whether the right to protect a setoff by deferring payment under
3 § 542(b) is to be interpreted as prohibited under § 362(a)(3).

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

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

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

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

1 § 1141 and by the terms of the plan itself. Section 1141 provides
2 that after a reorganization plan is confirmed, all property "dealt
3 with by the plan" is free and clear of creditors' claims and
4 interests and the debtor is discharged from any debt dealt with by
5 the plan arising before the date of confirmation. For a claim or
6 interest to be dealt with by the plan, the plan must acknowledge,
7 and make explicit provision for the treatment of, the claim or
8 interest. In re Work, 58 Bankr. 868, 871 (Bankr. D.Or. 1986),
9 citing In re Gregory, 19 Bankr. 668 (Bankr. 9th Cir. 1982).

10 The Northwest Marine plan does not discharge the Navy's setoff
11 claim because the plan does not acknowledge this claim or make
12 explicit provision for it. Indeed, while the plan provides a five
13 percent debenture for unsecured claims, there is no provision
14 dealing with unnamed secured creditors. Because the setoff is
15 not "dealt with" by the plan, the funds in the suspense account
16 are not free and clear of all claims and interests of creditors.
17 Thus, the Navy's secured claim under § 553(a) survived the
18 confirmation of the reorganization plan. See also In re
19 Commercial W. Fin. Corp., 761 F.2d 1329, 1336-37 (9th Cir.
20 1985)(holding that based on due process considerations, it is
21 inappropriate to resolve secured claims against the estate by
22 discharging them through confirmation instead of through the
23 adversary claims procedure in bankruptcy).

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

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

8 CONCLUSION

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

11 DATED this 23 day of May, 1990.

12 Malcolm F. Marsh
13 Malcolm F. Marsh
14 United States District Judge

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25 ² Because I find that the Navy's setoff claim is a secured
26 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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UNITED STATES OF AMERICA,)
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Civil No. 90-223-MA

ORDER

In re)
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Debtor.)

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1 - ORDER

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

8 IT IS SO ORDERED.

9 DATED this 23 day of May, 1990.

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11 Malcolm F. Marsh
12 Malcolm F. Marsh
United States District Judge
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2 - ORDER

