UNITED STATES BANKRUPTCY COURT
DISTRICT OF MINNESOTA
THIRD DIVISION

In re:

Georgia Gabor, Inc.,
Debtor.

Chapter 7 Case

BKY Case No. 3-91-3218

Brian F. Leonard,Trustee,
Plaintiff,

ADV No. 6-91-22

ORDER

vs.

Southeast Bank, N.A.,
Defendant.

This matter came before the Court for hearing on June 6, 1991, on Plaintiff's motion for a temporary restraining order, and on Defendant's motion for relief from stay. This is a core proceeding under Sections 1334 and 157. The Court has jurisdiction to determine this matter under 28 U.S.C. Section 157.

I.

In 1989, two letters of credit were issued by Southeast Bank, N.A. (Bank) on behalf of Georgia Gabor, Inc. (Debtor), in favor of Reliance Insurance Company (Reliance). The first was issued on October 13 for $115,000, and the second was issued on December 27 for $85,000. A third letter of Credit was issued to Clarendon Insurance Company (Clarendon) for $142,200 on July 24, 1990. The

October 30, 1990 and November 29, 1990 that the $85,000 and the $115,000 letters of credit would not be renewed, and that they would expire December 31, 1990. As a result, Reliance demanded payment on the letters of credit. The Clarendon letter of credit expires on July 24, 1991.

On December 17, 1990, an involuntary bankruptcy petition was filed against the Debtor. On December 21, Southeast and the Debtor entered into a new agreement, which provided that Southeast issue two new letters of credit in favor of Reliance to replace those set to expire on December 31. Additionally, the new agreement subsumed the Clarendon letter of credit, and provided that the Debtor execute a single note in the total amount of $342,000. The new note was secured by accounts receivable of the Debtor as well as deposit accounts at the Bank. Reliance was informed by the Bank of the new letters of credit and agreed not to draw on the earlier ones. The new letters were actually issued by the Bank on January 8, 1991.

Prior to the security agreement of December 21, 1990, the parties had an arrangement whereby the Debtor's accounts receivable were paid directly into a lock box account at the Bank, and then transferred into the Debtor's operating account. Although the operating account was subject to setoff by the Bank, pursuant to the earlier letter of credit agreements, the account was fully accessible by the Debtor.

The security agreement of December 21, 1990, provided for two new Debtor accounts to be created at Southeast. Receipts from the lock box were transferred into a special account where they were divided into equal amounts. From the special account, 50% of the funds were transferred to the Debtor's operating account (which the debtor controlled), and 50% were transferred to a "cash collateral" account over which the Debtor had no control or access. The "cash collateral" account was intended to secure the new letters of credit issued in favor of Reliance on January 8, 1991.

The $142,200 Letter of Credit was subsequently drawn by Clarendon on January 30, 1991. On March 1, 1991, the replacement $85,000 and $115,000 letters, which were issued in favor of Reliance on January 8, 1991, were drawn by Reliance.

The Bank moved for relief from stay in February 1991, to set off the operating account against the resulting liability of the Debtor from the draw on the $142,000 Clarendon letter of credit. By the initial hearing date of March 7, 1991, the Reliance letters of credit had also been drawn in the total amount of $200,000. No order for relief had been entered against the Debtor and no trustee had been appointed in the case. The attorney for the petitioning creditors appeared in the proceeding and objected to relief from stay regarding the operating account, but no mention was made by anyone of the "cash collateral" account. No other party appeared or objected in the proceeding.

On March 15, 1990, the Court issued an order, pursuant to the March 7 hearing, which froze the operating account, pending final determination of Southeast's Motion for relief from stay to set off that account. Pursuant to the order, Southeast transferred approximately $55,000 from the special and operating accounts to a separate interest bearing escrow account.(FN1) The Order allowed Southeast to set off the Debtor's post-petition cash deposits in any account against any post-petition debts to Southeast incurred by the debtor in the ordinary course of business. Pursuant to that provision, Southeast applied the entire proceeds of $77,800 from the "cash collateral" account against Southeast's $342,200

An order for relief under Chapter 7 of Title 11 was entered on March 26, 1991. On April 2, 1991, the Court conditionally granted Southeast's motion for relief from stay to set off against the frozen operating account, but only if the Trustee either consented to the motion or did not object.

The Trustee has not only objected to the motion for relief from stay, but has also commenced an adversary proceeding against the Bank, alleging that:

> 1. The Bank has not shown that the funds in the frozen account are deposits received prepetition, and the Bank has no right to set off post-petition deposits against prepetition debt arising from the Clarendon letter of credit draw, citing 11 U.S.C. Sections 541, 552, and 553.
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> 2. All payments of accounts receivable made through the lock box into the Debtor's deposit account during the 90 days prior to filing of the case, were engineered by the Bank, in collusion with the Debtor, to build up the Debtor's deposit account for the purpose of obtaining a right of setoff. Accordingly, the Trustee claims, no post-petition setoff is proper, citing 11 U.S.C. Section 553(a)(3).
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> 3. The December 21, 1990 agreement, the expanded security interests provided therein to the Bank, and the post-petition "setoff" of the "cash collateral" account, constitute transfers for which the Debtor received no new value. Accordingly, the Trustee claims, the transfers are avoidable, citing 11 U.S.C. Section 549(a).

The Trustee seeks, in the adversary proceeding, an accounting from the Bank regarding these matters, a judgment avoiding the post-petition transfers identified above, and an injunction against future transfers.

Final hearing was held on the Bank's motion for relief from stay and on the Trustee's motion for temporary restraining order on June 6, 1991.

II.

The Bank has not shown that it is entitled to relief from the automatic stay. The Trustee has asserted a claim that the Bank improperly arranged with the Debtor, prepetition, to turn accounts receivable (in which the Bank had no security interest) into debt deposits owing to the Debtor, for the specific purpose of creating a right of setoff in the converted receivables. Additionally, the Trustee claims that: the Bank is not entitled to rely on its post-petition agreements with the Debtor because they are supported by no new value given by the Bank, making them avoidable under Section 549(a); and, all funds in the account are post-petition deposits, which are not subject to the Bank's prepetition security agreement covering the letters of credit. The Trustee is entitled to litigate these claims prior to the Bank's exercise of any setoff.

Although the Trustee's motion seeks relief by temporary restraining order, the matter was heard in the context of a request for preliminary injunction. The Bank appeared and presented testimony and arguments regarding the matter, and there appears to be no reason why the motion should not be considered as a request for preliminary injunction. Relevant factors to the consideration are: whether the Trustee will probably succeed on the merits of the litigation; whether he will be irreparably harmed if the injunction is not issued; the balance between the harm if the injunction is not issued against the harm to the adverse party if it is issued; and, any significant public interest concerns that can be identified. See: Dataphase Systems, Inc. v. C. L. Systems, Inc., 640 F.2d 109 (8th Cir. 1981).

The Trustee has offered no significant evidence of prepetition conduct by the Bank that would prohibit setoff under 11 U.S.C. Section 553(a)(3). Furthermore, continuing relevance of that allegation is uncertain, since it is undisputed that no prepetition setoff has been made, and, all funds that are subject to the present dispute consist of post-petition deposits.(FN3) Successful litigation by the Trustee of his allegation pertaining to Section 553(a)(3), is uncertain, based on the present record.

The Trustee's prospects for successful litigation regarding the post-petition agreement of the parties and the Trustee's right of avoidance under Section 549(a) are also uncertain. The position of the Bank was clearly and dramatically improved as a result of the December 21, 1990 agreement. The Bank received an expanded secured position in both post-petition accounts receivable and post-petition deposit accounts of the Debtor against what appears in substance to be prepetition debt that had been secured only by prepetition deposits.

Certainly, the Bank gave up nothing, and the Debtor received nothing, by the post-petition issue of new letters of credit and inclusion of the Clarendon letter in the agreement. The Clarendon letter had not been drawn and was not set to expire until July, 24, 1991. Regarding the Reliance letters, the Bank knew that if it did not issue new letters of credit, the earlier ones would be drawn. The agreement appears to reflect a post-petition attempt by the Bank to expand its collateral base for the prepetition letter of credit liability, in an impermissible overreaching under the Bankruptcy Code.

But the fact that the Bank might have overreached in the value to the Debtor in the agreement. Upon the filing of the involuntary petition on December 17 1990, the deposit account, as then constituted, became the Bank's cash collateral under the old the Bank (See 11 U.S.C. Section 303(f)), Southeast was not without rights and remedies regarding its collateral. It had the right to segregate and freeze the prepetition funds in the account and seek

Bank's position was particularly vulnerable because, regardless of the prepetition agreement of the parties, 11 U.S.C. Section 552(a) stripped the Bank's lien from post-petition deposits, while, absent court order or agreement of the parties, the Debtor was not prohibited from using prepetition deposits.

Arguably, the Bank gave new value in the December 21 agreement by allowing the Debtor the use of its remaining prepetition cash collateral from the effective date of the post-petition agreement. If so, arguably, the Bank is entitled to its agreed-upon post-petition secured status to the extent of prepetition cash collateral used from the effective date of the agreement. This "replacement lien" arrangement is common in addressing the competing needs and interests of debtors and secured creditors in Court-supervised and approved adequate protection proceedings that regularly occur in voluntary cases.

Simply because this was an unsupervised post-petition agreement in an involuntary case, and because it might have included more for the Bank than what the Bank is entitled to under the Code, does not necessarily mean that the Bank is entitled to nothing under the agreement. 11 U.S.C. Section 549(b) protects "gap transfers" in involuntary cases to the extent of post-petition value given in exchange for the transfers. The record does not disclose how much, if any, prepetition deposits existed on the effective date of the December post-petition security agreement between the Debtor and the Bank. Whether, and to what extent, the Trustee might prevail in litigation regarding the post-petition agreement are uncertain, based on the present record.

Regarding the question of harm, the Trustee's expressed concern is with the Bank's apparent financial soundness, and the possibility that it might be taken over by the Resolution Trust Corporation before this litigation is finally determined. The Trustee points to recent articles in the Wall Street Journal about the Bank's situation, and argues that the safe and prudent course for the Court to follow would be to order that the frozen account be removed from the Bank for safe keeping in a more financially sound institution.

Ordinarily, articles in newspapers are not competent evidence particular articles are speculative and general in nature.(FN4) Furthermore, it has not been shown that the account is not fully insured and that the funds would likely be unavailable in the event that the Bank does fail.

The Trustee stresses lack of harm to the Bank and public interest considerations underlying the Bankruptcy Code in urging turnover of the deposit account at this early stage of the litigation. Ordinarily, lack of harm to an adverse party and general public interest considerations do not, standing alone, justify the issuance of a preliminary injunction. There must exist, in addition, either irreparable harm to the movant if no injunction be issued, or a showing of probable success on the merits.

It would be inappropriate to order turnover of the deposit entitled only to an order enjoining the Bank from further exercise of any setoff under purported authority of the Court's March 15, 1991, order granting relief from stay.
See: footnote 2.

III.

Based on the foregoing, IT IS HEREBY ORDERED:

1. The motion of Southeast Bank, N.A. for relief from stay is denied.

2. The motion of the Trustee for a preliminary injunction is granted to the extent that the Bank is enjoined from any further setoff against, or appropriation of, estate property under the Court's order of March 15, 1991.

3. All other requested relief is denied.

Dated: July 1, 1991. By The Court:

Dennis D. O'Brien
U.S. Bankruptcy Judge

(FN1) There presently exist approximately $64,000 in disputed funds in the account, all of which are post-petition deposits.
END FN

(FN2) This is a good place for an admission of judicial confusion. The Bank readily acknowledges that the disputed account consists entirely of post-petition deposits. The Bank argues that it is entitled to offset the deposit account because the debt that the account secures, is also post-petition. According to the Bank's theory of the case, the nature of this account, as collateral, is no different from the nature of the "cash collateral" account deposits that it applied against the entire $342,000 debt in stated reliance on the permissive language in the March 15 order. The theory is that the account is post-petition security for post-petition debt. What is unclear is why the Bank thought it permissible under the March 15 order for it to "offset" the "cash collateral" account when the Bank was specifically prohibited from offsetting the deposit account.

The "cash collateral" account was a repository account where the Bank's claimed cash collateral was stored, under its control, prior to the Bank's payment of the funds to itself in satisfaction of claimed secured debt. The permissive language in the March 15, 1991, order allowing the Bank to set off certain post-petition deposits against certain post-petition debts was not an adjudication, or the result of an adjudication, of entitlement to the "cash collateral" account. The Court was not aware of the "cash collateral" account at the time that the order was entered; nor was the Court aware of the December 21 post-petition agreement between the Bank and the Debtor. At best, the order arguably removed the then-existing impediment to the Bank of the 362 stay. The relief was not intended to preclude a later appointed trustee from avoiding the transfer if it be shown to be avoidable under 11 U.S.C. Section 549.
END FN

(FN3) The allegation might have continuing relevance to the issue of the Bank's right to a replacement lien in post-petition property for prepetition cash collateral used by the Debtor after the December post-petition security agreement was executed.
END FN

(FN4) One article states that NCNB Corp. is interested in acquiring Southeast, and that NCNB is discussing the possibility with regulators in hopes of making a government assisted deal. The other states that Southeast has suffered six consecutive quarterly losses, has a smaller capital ratio than regulators would like it to maintain, has suffered 7% customer deposit decline in the first quarter, and that its convertible subordinated debt rating fell from B+ to CCC.
END FN