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Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code

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FREEZING THE DEBTOR'S ACCOUNT: A BANKER'S DILEMMA UNDER THE BANKRUPTCY CODE

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The Bankruptcy Code does not explicitly answer the question of whether a bank owed money by its customer may temporarily freeze the customer's account upon learning of the customer's bankruptcy. The authors analyze the leading judicial decisions in support of a temporary freeze as well as those against. Casting an experienced eye on the interplay of several Code provisions, the authors present a way out of the morass: allow for a temporary freeze pending a subsequent determination of the adequacy of the bank's protection upon the debtor's request for use of the funds.

Setoff Under the Former Bankruptcy Act

A bank's right to offset a customer's funds on deposit against an obligation owed to the bank without the need for obtaining judicial approval is well recognized in American law.[1] This right was preserved in the former Bankruptcy Act, which permitted all creditors to offset mutual debts owed between them and the debtor.[2] For example, if a creditor had a $100,000 unsecured claim against the debtor and, on an unrelated transaction, the creditor owed the debtor $20,000, upon the commencement of a bankruptcy case the creditor could have offset one debt against the other for a net claim of $80,000. It is important to appreciate the advantage that setoffs gave creditors. In the absence of the right of setoff, the creditor would have had a $100,000 unsecured claim while having to pay $20,000 to the estate. Assuming a 10 percent dividend in bankruptcy, without the setoff the creditor would receive $10,000 but would pay $20,000

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1 See Loyd, "The Development of Setoff," 64 U. Pa. L. Rev. 541 (1916); Note, "Setoff in Bankruptcy: Is the Creditor Preferred or Secured?" 50 U. Colo. L. Rev. 511 (1979).

2 Former Bankruptcy Act § 68. The former Act was enacted in 1898 and governs all bankruptcy cases commenced prior to October 1, 1979. The Bankruptcy Code, which is Title II of the United States Code, was created by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, and governs all bankruptcy cases commenced on or after October 1, 1979.

to the trustee for a net loss of $10,000. By exercising the right of setoff, the same creditor would receive a dividend based on an $80,000 unsecured claim without paying anything to the estate.

It is not surprising that banks are usually the primary beneficiaries of the right of setoff. Deposits are treated as creating debts owed by the bank to its customer which may be set off against the customer's loan obligations.[3] To borrow from the above hypothetical, under the former Bankruptcy Act, a bank owed $100,000 could have set off the balance of $20,000 in the debtor's checking account immediately upon learning of the customer's bankruptcy even without the need for judicial action.

Setoff Under the Bankruptcy Code

The Bankruptcy Code continues to recognize a bank's substantive right of postpetition setoff. Section 553(a) specifically provides that the Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case." Certain exceptions to the right of setoff are contained in the Code, such as the prohibition of setoffs of creditors' claims which are disallowed under Section 502.[4] A right of setoff will be denied if the creditor received the claim by means of an assignment by another entity after the bankruptcy petition is filed or within ninety days before bankruptcy while the debtor was insolvent.[5] Deliberate manipulation by a creditor to obtain setoff rights on the eve of bankruptcy is also prevented by prohibiting setoffs to the extent that the debt owed to the debtor was incurred within ninety days prior to bankruptcy, while the debtor was insolvent, for the purpose of

[3] The leading case that supports the bank's right to set off the balance of a bank account is New York County Nat'l Bank v. Massey, 192 U.S. 138 (1903). See also *In re* Applied Logic Corp., 576 F.2d 952 (2d Cir. 1978), in which a bank was permitted to set off certificates of deposit held by the bank against a debt owed to it. Of added interest is the discussion of special accounts and the application of the debtor's payments where the creditor has secured or guaranteed open accounts. Compare, however, Goldstein v. Franklin Square Nat'l Bank, 107 F.2d 393 (2d Cir. 1939), which held that the deposit of funds by the insolvent debtor in a checking account for the deliberate purpose of permitting the bank to offset the deposit against an antecedent debt, constituted a voidable preference and was not protected by the setoff provision of the Bankruptcy Act.

[4] Bankruptcy Code § 553(a)(1).

[5] Bankruptcy Code § 553(a)(2). The debtor is presumed to have been insolvent during the 90-day period prior to bankruptcy. See § 553(c).

obtaining a right of setoff.[6] Moreover, a prepetition setoff exercised within ninety days *prior* to the commencement of the case may be recovered by the trustee to the extent that the creditor's position had been improved during that period.[7] In the usual case, however, the bank's substantive right of setoff which had not been exercised prior to the filing of a bankruptcy petition is preserved by the Code as it was under the former Act.

The most significant change made by the Bankruptcy Code with respect to a creditor's postpetition right of setoff was a procedural one; the right of setoff is now within the broad scope of the Code's automatic stay. A bankruptcy petition operates as a stay of "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor."[8] The reason for applying the stay to the exercise of setoff rights is to prevent further aggravation of the debtor's cash flow problem because of the loss of bank accounts and accounts receivable. If the bank could set off all bank accounts upon the filing of a chapter 11 petition, the debtor's chances for a successful reorganization would probably vanish because the continuation of business in the ordinary course would become difficult if not impossible. Even in liquidation cases, the continuation of business for a temporary period may be appropriate to maintain the debtor's value as a going concern.[9]

The automatic stay was never designed to affect substantive rights of creditors, but is a procedural halt to aid in an orderly administration of the estate and/or successful reorganization. Thus, a creditor whose right of setoff is stayed is entitled to adequate protection.[10] This protection may come in different forms and mechanisms, such as granting the bank a lien on specific property.[11] However, if the bank wants to exercise the right of setoff because it feels it is inadequately protected and would be adversely affected by the withdrawal

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[6] Bankruptcy Code § 553(a)(3). This provision follows Goldstein v. Franklin Square Nat'l Bank, 107 F.2d 393 (2d Cir. 1939).

[7] Bankruptcy Code § 553(b). See Weintraub & Resnick, *Bankruptcy Law Manual*, ¶ 5.10[2] (1980); Freeman, "Setoff Under the New Bankruptcy Code: The Effect on Bankers," 97 Banking L.J. 484, 498-504 (1980); Orr & Klee, "Secured Creditors Under the New Bankruptcy Code," 11 U.C.C.L.J. 312, 335-338 (1979).

[8] Bankruptcy Code § 362(a)(7).

[9] See Weintraub & Resnick, note 7 *supra*, ¶ 5.10[3].

[10] Bankruptcy Code § 362(d)(1).

[11] See Bankruptcy Code § 361.

of funds on deposit, a court order would have to be obtained by the bank.[12] In the absence of judicial action, the stay continues.

The Argument for Prohibiting the Freeze

Kenney's Franchise

If the analysis of a bank's right of setoff stops at this point, one may conclude that the bank may not refuse to allow the debtor in possession or trustee to withdraw funds on deposit unless and until a court order granting relief from the stay is obtained. Such an analysis was made by the bankruptcy court in *In re Kenney's Franchise Corp.*,[13] one of the first decisions regarding a bank's right to freeze a debtor's account.

In *Kenney's Franchise*, the debtor opened a general checking account in Central Fidelity Bank in 1978, in the regular course of its business. In 1979, the bank loaned the debtor $95,000, secured by liens on equipment and fixtures worth $69,000 and used in connection with one of the debtor's fast food operations. On March 5, 1980, the debtor filed a chapter 11 petition at which time the balance remaining on the loan was $63,000 and the resale value of the collateral was approximately $25,000. The following day, the bank learned of the petition and without court approval immediately "froze" the checking account with a balance of approximately $12,000. Although it was frozen, the bank did not apply the proceeds of the account to the satisfaction of the debt.

The trustee for the debtor filed a complaint seeking recovery of the $12,000 claimed to be improperly held by the bank as a result of the freeze on the account. The bank's answer and counterclaim alleged that the bank had a "banker's lien" upon the account and was entitled to adequate protection pursuant to Section 362(d) before the debtor could have use of the funds. Moreover, the collateral subject to the banker's lien was "cash collateral"[14] and, therefore, the debtor had no right to use it without first obtaining a court order pursuant to Section 363(c)(2). In essence, the bank claimed a secured position with a lien on cash collateral, which is protected by the Code's special provision that prohibits the use of such collateral unless and

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[12] Bankruptcy Code § 362(d).

[13] 12 B.R. 390 (W.D. Va. 1981), *aff'd*, Civ. Action No. 81-0259 (W. Va. March 24, 1982), *rev'd on reargument*, 22 B.R. 747 (W.D. Va. 1982).

[14] See Bankruptcy Code Section 363(a), which defines "cash collateral" to include deposit accounts as well as other cash equivalents.

until the debtor obtains judicial approval. Since the debtor's trustee did not obtain such approval, the bank argued that its temporary freeze was appropriate.

The bankruptcy court rejected the bank's position and held that the freeze was in violation of the Code's automatic stay provision. "The language of the stay provision is broad and all-encompassing." [15] The court stated that, in order to avoid application of the stay to the right of setoff, the bank invoked "as a protective measure what is denominated in parlance and nomenclature as a 'freeze.' " [16] The court noted the financial terminology of "freeze," which it found in the *Random House Collegiate Dictionary,* means, "to render impossible of liquidation of collection." [17] The court rejected the bank's argument that the "freeze" did not constitute the exercise of the right of setoff because the balance of the account was not applied to the debt. The court found that the bank exercised dominion and control over the account to the exclusion of rights of the debtor and it failed to honor checks which may have been written upon the account. This conduct was sufficient to constitute the exercise of the right of setoff in violation of the stay.

The bankruptcy court in *Kenney's Franchise* also rejected the bank's characterization of its position as that of a lienor. "The Bank's position arises from an erroneous construction of the law. What the Defendant claims as a 'bank's lien' is actually no more than the right of set-off." [18] Quoting Professor Gilmore, the court noted, "A bank's right of set-off against a depositor's account is often loosely referred to as a 'banker's lien,' but the 'lien' usage has never led anyone to think that the bank held a security interest in the bank account." [19] Because the bank had a right of setoff only, and not a lien on any specific collateral, the funds on deposit could not be characterized as cash collateral under Section 363. Accordingly, the bankruptcy court concluded that, as an unsecured creditor with a right of setoff automatically stayed upon the filing of the bankruptcy petition, the bank acted improperly when it "froze" the debtor's account without obtaining judicial relief from the stay. In that case the blow

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[15] *In re* Kenney's Franchise Corp., note 13 *supra*, at 391-392.
[16] *Id.* at 392.
[17] *Id.* at 392 n.1.
[18] *Id.* at 392.
[19] *Id.* at 394.

was softened when the court refrained from imposing sanctions against the bank because "the freeze was under a good faith claim." [20]

Arguments in Favor of Bank's Right to Freeze

Although *Kenney's Franchise* was originally affirmed by the district court[21] and is followed in other courts,[22] its analysis of the issue was seriously flawed. Consideration of Section 553, which recognizes the right of setoff, and of Section 362(a)(7), which applies the automatic stay, merely begins the proper reasoning, but does not end it. Although the stay applies to the right of setoff, Section 506 of the Code gives the bank a secured claim for bankruptcy purposes regardless of whether the right of setoff constitutes a "banker's lien." In particular, Section 506(a), which was not even mentioned in the bankruptcy court's opinion in *Kenney's Franchise*, provides that "[a]n allowed claim of a creditor . . . that is subject to setoff under section 553 of the title, is a secured claim . . . to the extent of the amount subject to setoff. . . ." The first question that comes to mind after reading Section 506 is, "If the claim is secured, what is the collateral?" Although Congress never expressed it in the Code, it is obvious that the claim is secured by the funds in the bank account. Such collateral is "cash collateral" under Section 363(a) and the debtor or the trustee "may not use, sell or lease cash collateral" unless the creditor consents or "the court, after notice and a hearing, authorizes such use. . . ." [23]

When Sections 553(a), 362(a)(7), 363(c)(2), and 506(a) are read together, there is an interesting result which supports the bank's right to temporarily freeze the account. Sections 553 and 362(a)(7) lead to the conclusion that the bank may not deprive the debtor in possession or trustee of use of the funds on deposit without obtaining a court order, while Sections 506(a) and 363(c)(2) lead to the conclusion that the debtor in possession or trustee may not use such funds until it obtains a court order. The lingering question, therefore, relates to

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20 *Id.* at 395.

21 Civ. Act. No. 81-0259 (W.D. Va. Mar. 24, 1982).

22 See *In re* Cusanno, 17 B.R. 879, 882 (E.D. Pa. 1982), a chapter 13 case, in which the court stated: "[W]e conclude that the action of the bank in placing an 'administrative hold' on the debtors' checking account was a violation of the automatic stay and we will, therefore, direct the bank to release that hold." See also *In re* Nelson, 6 B.R. 248 (D. Kan. 1980), a chapter 7 liquidation case in which a bank was held in contempt for freezing the debtors' account.

23 Bankruptcy Code § 363(c)(2).

the rights of the parties before *anyone* obtains a court order. Since the bank may not exercise the right of setoff, and the debtor or trustee has no right to use the funds, a temporary "freeze" or administrative hold which maintains the status quo pending judicial action appears to be the only logical way of reconciling these Code provisions. Based on similar reasoning, the court in *In re Gazelle, Inc.*[24] held that a bank's refusal to release funds in a "frozen" account in the absence of a court order authorizing the debtor to use such "cash collateral" did not violate the automatic stay and could not be the basis for a contempt ruling.

Is the Freeze an Exercise of Setoff?

Another issue on which courts are divided and which relates to the bank's right to temporarily freeze the debtor's account is whether the freeze, in fact, constitutes an exercise of a setoff. If the freeze is not an exercise of a setoff, then it could be argued that it does not violate the stay in any event. This argument was made unsuccessfully in the bankruptcy court in *Kenney's Franchise,* as it was in the analogous case of *In re Mealey.*[25] In *Mealey,* the Internal Revenue Service withheld a taxpayers' refund after the taxpayers had filed a joint chapter 13 petition and after the IRS filed an unsecured tax claim. The IRS argued that it did not violate the stay because it did not exercise the right of setoff; it merely "placed the funds in a 'suspense account' under a 'freeze code' pending the lifting of the automatic stay."[26] The court disagreed, fined the IRS $200 for contempt, and awarded costs and attorneys' fees to the debtors. The court stated:

> The crux of this argument is that the determination of when a setoff occurs is purely an accounting matter. Although the IRS retains the funds and the debtor is denied the use of the funds, the IRS maintains that a setoff does not occur until an appropriate bookkeeping entry is made. This argument exalts form over substance to an impermissible extent. . . . An artificial measure, such as a bookkeeping entry, cannot be determinative. To rule otherwise would allow a creditor to circumvent the automatic stay by merely delaying the entry of a setoff on his books.[27]

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[24] 17 B.R. 617 (W.D. Wis. 1982).
[25] 16 B.R. 800 (E.D. Pa. 1982).
[26] *Id.* at 801.
[27] *Id.* at 802; see also *In re* Hackney, 20 B.R. 158 (D. Idaho 1982).

In contrast to the bankruptcy court in *Kenney's Franchise* and *Mealey,* the bankruptcy court in *In re Carpenter*[28] distinguished between the freezing of an account and the exercise of setoff rights. The court viewed the right of setoff under Section 553 as separate and apart from Section 542, which governs the turnover of property to the estate. In essence, Section 542(b) requires an entity that owes a debt that is property of the estate to pay the debt to the trustee, "except to the extent that such debt may be offset under Section 553." The court reasoned that the phrase "may be offset" in Section 542(b) assumes that the setoff had not been exercised. "Obviously, if the debt had been set off, it could not be considered property of the estate. Thus, Congress has recognized a significant distinction between the withholding of payment and the exercise of the setoff right."[29] According to this analysis, prior to the actual exercise of the setoff, a bank may refuse to turn the balance of the debtor's checking account over to the debtor or the trustee by virtue of Section 542(b). Since such a refusal to turn over funds would not be the exercise of setoff rights, such a "freeze" would not violate the automatic stay.

Support for the reasoning in *Carpenter* may be found in the 1975 court of appeals decision in *Baker v. National City Bank of Cleveland,*[30] which provided that three steps must be taken to accomplish a setoff: (1) there must be a decision to exercise the right of setoff; (2) there must be a subsequent action completing the setoff; and (3) a record verifying that the setoff was completed must be made, such as a bookkeeping entry.

It is not surprising that the soundness of the reasoning in *Carpenter* and *Gazelle* became the basis for the district court's reversal of the bankruptcy judge's decision in *Kenney's Franchise* upon reargument of the case.[31]

Finally, courts are split on the question of whether the automatic stay of setoffs applies only in reorganization cases. For example, in *Carpenter,* a liquidation case, the court distinguished the *Kenney's Franchise* chapter 11 case, noting that: "The legislative history of the Reform Act indicates that the exercise of setoff rights was included in the automatic stay in order to protect ongoing businesses in

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28 14 B.R. 405 (M.D. Tenn. 1981).
29 *Id.* at 407.
30 511 F.2d 1016 (6th Cir. 1975); see also *In re* McCormick, 5 B.R. 726 (N.D. Ohio 1980).
31 See note 15 *supra*.

reorganization cases and that there is little justification for applying it in liquidation cases."[32] In contrast to *Carpenter*, however, the bankruptcy court in *In re Nelson*[33] applied the automatic stay to the right of setoff when it held a bank in contempt on a chapter 7 liquidation case. It is important to note that, despite the legislative history, the Code makes no distinction among cases under chapters 7, 11, and 13 with regard to the automatic stay of setoff rights.

Conclusion

The Bankruptcy Code is a complex web often requiring the reconciliation of numerous sections to arrive at a determination of rights. The seemingly uncomplicated question of whether a bank owed money by its customer may temporarily freeze the customer's account upon learning of its bankruptcy cannot be answered adequately without considering the interplay of several Code provisions. When only Sections 553(a), recognizing the right of setoff, and 362(a)(7), applying the automatic stay to setoffs are considered, as was done by the bankruptcy court in *Kenney's Franchise,* an erroneous conclusion is reached which prohibits the freezing of funds without court approval.

When, however, setoff rights are viewed as secured claims under Section 506(a) and the deposited funds are treated as cash collateral pursuant to Section 363(c)(2), the right of the trustee or debtor to have use of the bank account balance without judicial approval is no greater than the bank's right to withhold the funds. Thus, a temporary freeze should be permissible pending a subsequent determination of the adequacy of the bank's protection upon the debtor's request for use of the funds. In view of the extreme liquidity of funds on deposit, permitting the temporary freeze serves to give banks needed protection against the immediate dissipation of its cash collateral and resulting destruction of its right of setoff before it has an opportunity to be heard in bankruptcy court. This analysis would enable a bank to put an administrative hold on the account to maintain the status quo regardless of whether a temporary freeze constitutes the exercise of a setoff or whether the automatic stay is applicable to setoffs in reorganization cases only.

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[32] *In re* Carpenter, note 28 *supra,* at 407. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 183 (1977); Ahart, "Bank Setoff Under the Bankruptcy Reform Act of 1978," 53 Am. B.L.J. 205, 214 (1979).

[33] 6 B.R. 248 (D. Kan. 1980).