OBA Bankruptcy and Reorganization Law Section:

The United States Supreme Court Determines That A Bank Is Allowed To Place An Administrative Freeze On A Debtor's Account

By Gary D. Hammond

On October 31, 1995, the United States Supreme Court decided that a bank has a right to place an administrative freeze on a debtor's account when the debtor files bankruptcy. In *Citizens Bank of Maryland v. Strumpf*,[1] the United States Supreme Court settled a major issue regarding the ability of a financial institution to place an administrative freeze on a debtor's account when he or she files bankruptcy and owes the financial institution at the time of filing. This article will discuss this case and the ramifications it has for financial institutions.

Prepetition, Citizens Bank of Maryland ("Citizens Bank") loaned David Strumpf ("Strumpf") $5,068.75, evidenced by an unsecured consumer note. The note expressly granted Citizens Bank the right of setoff. On January, 25, 1991, Strumpf filed a voluntary Chapter 13 petition. At the time of filing, Strumpf had $11,279.86 in a checking account at Citizens Bank.

Seven months after confirmation of Strumpf's Chapter 13 plan, Citizens Bank placed an administrative freeze on Strumpf's account and filed a motion for relief from stay.[2] Strumpf filed a motion for contempt against Citizens Bank, alleging that the bank had violated the automatic stay by placing an administrative freeze on his account. The bankruptcy court decided Strumpf's motion first, holding that Citizens Bank's administrative freeze was a setoff in violation of the automatic stay. The bankruptcy court awarded Strumpf punitive damages and attorneys' fees for Citizens Bank's violation of the automatic stay. The bankruptcy court also ordered Citizens Bank to lift the administrative freeze.

Several weeks later, the bankruptcy court granted Citizens Bank's motion to lift stay and authorized the bank to setoff Strumpf's account against the unpaid loan. Unfortunately, by the time the bankruptcy court granted the motion to lift stay, Strumpf had reduced the account to zero.

On appeal, the district court reversed the bankruptcy court's order that Citizens Bank's administrative freeze had violated the automatic stay. On appeal, the court of appeals reversed the district court's order, determining that an administrative freeze "...is tantamount to the exercise of a right of setoff and thus violates the automatic stay...."[3] The United States Supreme Court granted *certiorari* to resolve the dilemma.[4]

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The United States Supreme Court began its discussion by stating that a right of setoff "...allows entities that owe each other money to apply their mutual debt against each other, thereby avoiding 'the absurdity of

making A pay B when B owes A.'"[5] The United States Supreme Court also recognized that Citizens Bank had a right of setoff against Strumpf prior to Strumpf filing bankruptcy and that Strumpf's filing bankruptcy created the automatic stay.

According to the United States Court, the "...principal question for decision is whether (Citizens Bank's) refusal to pay its debt to (Strumpf) upon the latter's demand constituted an exercise of the setoff right and hence violated the stay."[6] Having stated the issue, the United States Supreme Court proceeded to discuss why Citizens Bank's action was not a violation of the automatic stay.

The United States Supreme Court began its discussion by stating that Citizens Bank had not permanently and absolutely refused to pay its debt to Strumpf, but only while it sought relief from the automatic stay. The United States Supreme Court narrowed the issue to whether the administrative freeze was a setoff. The Court held that the administrative freeze was not a setoff because Citizens Bank's motion for relief from automatic stay did not purport to permanently reduce Strumpf's account by the amount of the defaulted loan. According to the Court, a requirement of such an intent "...is implicit in the rule followed by a majority of jurisdictions addressing the question that a setoff has not occurred until three steps have been taken: (i) a decision to effectuate a setoff, (ii) some action accomplishing the setoff, and (iii) a recording of the setoff."[7] The United States Supreme Court noted that even if state law were different, the question whether a setoff under section 362(a)(7) has occurred is a matter of federal law, and other provisions of the bankruptcy code would lead it to the same requirement of an intent to permanently settle the accounts.[8]

Next, the United States Supreme Court analyzed the interplay between 11 U.S.C. § 542(b) and § 553(a).[9] Section 542(b) requires an entity to turn over to the trustee property of the estate except to the extent that the property may be used to offset a debt owing the creditor by the debtor. Section 553(a) states that a right of setoff is not affected by the debtor filing bankruptcy. Therefore, according to the United States Supreme Court, "(i)t would be an odd construction of § 362(a)(7) that required a creditor with a right of setoff to do immediately that which § 542(b) specifically excuses it from doing as a general matter: pay a claim to which a defense of setoff applies."[10]

The United States Supreme Court also brushed away the argument that § 553(a) contained the caveat "...except as provided in...sections 362 and 363..." and, therefore, was a restriction on Citizens Bank's ability to place an administrative freeze on Strumpf's account. Although the United States Supreme Court recognized that this provision referred to section 362(a)(7), the Court stated:

> "...it is most naturally read as merely recognizing that provision's restriction upon when an actual setoff may be effected - which is to say, not during the automatic stay. When this perfectly reasonable reading is available, it would be foolish to take the § 553(a) 'except' clause as indicating that § 362(a)(7) requires immediate payment of a debt subject to setoff. That would render § 553(a)'s general rule that the Bankruptcy Code does not affect the right of setoff meaningless, for by forcing the creditor to pay its debt immediately, it would divest the creditor of the very thing that supports the right of setoff....It is an elementary rule of construction that 'the act cannot be held to destroy itself.'[11]

Finally, the United States Supreme Court refused to accept Strumpf's argument that Citizens Bank's administrative freeze violated sections 362(a)(3) and (6). According to the Court, such an interpretation would "...proscribe what § 542(b)'s 'except[ion]' and § 553(a)'s general rule were plainly intended to permit: the temporary refusal of a creditor to pay a debt that is subject to setoff against a debt owed by the bankrupt."[12]

Based on the United States Supreme Court's decision, financial institutions seem to have been given the green light to place administrative freezes on debtor's accounts when the debtor files bankruptcy, if the debtor owes the financial institution at the time of filing. Financial institutions should treat the administrative freeze as temporary and immediately file a motion for relief from stay. By doing so, the financial institutions should be able to stay within the parameters of the United States Supreme Court's decision.

1. 1995 WL 633458, October 31, 1995.

2. When Citizens Bank filed its motion for relief from stay, Strumpf owed $3,250.48 to Citizens Bank.

3. 37 F. 3d 155, 158 (4th Cir. 1994).

4. 514 U.S. ____ (1995).

5. 1995 WL 633458. The United States Supreme Court also correctly reasoned that federal law does not create a right of setoff; however, 11 U.S.C. § 553(a) provides that, with certain exceptions, whatever right of setoff exists is preserved in bankruptcy.

6. 1995 WL 633458.

7. 1995 WL 633458. **Citing** *Baker v. National Bank of Cleveland*, 511 F.2d 1016, 1018 (6th Cir. 1975); and *Normand Josef Enterprises, Inc. v. Connecticut Nat. Bank*, 646 A.2d 1289, 1299 (Conn. 1994).