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BANKS TAKE A RISK IN FREEZING A DEBTOR'S ACCOUNT DURING CHAPTER 7 PROCEEDINGS

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Introduction

What is a bank to do when an individual depositor files a chapter 7 bankruptcy petition? Do the turnover requirements of the US Bankruptcy Code allow the bank to put a freeze on the debtor's account, at least until the chapter 7 trustee advises the bank what to do with the funds? A recent decision from the Chief Bankruptcy Judge from the highly influential Southern District of New York highlights the risks that a bank takes when it freezes a debtor's bank account.

In re Weidenbenner – The Decision

The Weidenbenners (the "Debtors") were a married couple who filed chapter 7 bankruptcy petitions on March 7, 2014 (Case No. 14-35443 (CGM), Bankr. S.D.N.Y). At the time of the filing, the Debtors had four separate deposit accounts at their bank. In their bankruptcy petition, the Debtors claimed that all of the funds in the accounts were exempt pursuant to section 522(d)(5) of the Bankruptcy Code.

On March 12, five days after the filing, the bank placed an "administrative pledge" (i.e., a freeze) on all four of the accounts in the aggregate amount of $6,923.54. As a result of the accounts being frozen, a check written by the Debtors to Kohl's department store bounced and the Debtors were charged a $25 penalty by Kohl's.

On the same day that it froze the Debtors' accounts, the bank notified the chapter 7 trustee of the freeze and requested directions for what should be done with the funds. The bank did not, however, turn over the funds to the trustee. On March 17, the trustee directed the bank to release all of the funds to the Debtors, which the bank did that same day. Therefore, the funds were frozen for a total of five days.

The Debtors filed a motion alleging that the bank violated the automatic stay by placing the administrative pledge on their bank accounts. In response, the bank argued that it did not violate the stay because the funds in the accounts were no longer payable to the Debtors and because the bank was required to turn over the funds to the trustee pursuant to section 542(b) of the Bankruptcy Code. At an evidentiary hearing, an assistant vice president from the bank testified that the bank had an internal policy by which, when learning of an individual account holder's chapter 7 bankruptcy filing, an employee would review the account and determine the amount that should be frozen.

The freeze was only placed on accounts where the aggregate balance of funds the bank owed to the bankruptcy estate was $5,000 or more. The bank did not freeze any funds if the aggregate balance of the funds considered to be the property of the estate was less than $5,000. Moreover, the bank representative testified that the bank only freezes funds that it determines to be property of the estate and that other funds, including post-petition deposits, remain accessible by the debtor.

On December 12, 2014, the Bankruptcy Court issued its Memorandum Decision whereby it found that the bank had violated the automatic stay by freezing the funds in the Debtors' accounts. The filing of the bankruptcy petition "operates as a stay, applicable to all entities, of … any act to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate." The court held that balances in the accounts at the time of the bankruptcy filing became property of the bankruptcy estate and that, by placing a freeze on the Debtors' accounts, the bank necessarily exercised control over property of the estate. Mem. Dec. at 5. The court was especially troubled by the fact that the bank had unilaterally determined who was entitled to access the funds in the accounts even though freezing the accounts "was not mandated by the Bankruptcy Code, ordered by the court, or requested by the chapter 7 trustee." Id. at 6. In especially pointed language, the court held that it "cannot think of a better example of 'control over property of the estate.'" Id.

The court rejected the bank's argument that freezing funds was consistent with the Bankruptcy Code's turnover requirements. Section 542(b) provides that an entity that owes a debt to the debtor shall pay such debt to, or on the order of, the chapter 7 trustee. Here, the bank admittedly did not turn over the funds to the chapter 7 trustee. Further undermining the bank's argument was the fact that the $5,000 threshold set by its internal policy was "completely arbitrary" because "all property, no matter how miniscule it may be, is property of the estate" and therefore "under its own logic, the bank violates section 542(b) every time it fails to place an administrative freeze on [an] account with a balance below $5,000." Id. at 7.

As a result of the stay violation, the court awarded the Debtors damages in the amount of $25, plus attorneys' fees and expenses in the amount of $14,853.18. Thus, notwithstanding the *de minimis* amount of the Debtors' actual injury, the bank was held liable for a significant amount of attorneys' fees.

Implications

On January 12, the bank appealed the Bankruptcy Court's decision. Notwithstanding the pending appeal, the *Weidenbenner* case is a cautionary tale for banks dealing with New York account holders who have filed chapter 7 bankruptcy petitions. Those banks should review their internal policies to ensure that they do not unilaterally place an administrative pledge or freeze on a debtor's account. If these banks want to take action in response to a bankruptcy filing, they should follow the suggestions of the *Weidenbenner* Court and simply notify the chapter 7 trustee of the existence of the debtor's accounts and wait for the trustee to request that the balance of the accounts be turned over. Alternatively, the banks can seek guidance from the Bankruptcy Court. In no event should the bank take unilateral action and freeze a New York debtor's account. Otherwise, the bank could be subject to the draconian sanctions available under section 362(k) of the Bankruptcy Code for violating the automatic stay.

There are two very important caveats. First, in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995), the US Supreme Court held that a bank's temporary administrative freeze of a debtor's account while the bank sought to enforce its setoff rights did not violate the automatic stay. However, the *Weidenbenner* court held that *Strumpf* did not apply because the bank had stipulated that it was not a creditor of the Debtors' and had no right to setoff. Nonetheless, if a bank has a right of setoff against the debtor, the bank is permitted to place an administrative freeze on the account while the bank seeks relief from the automatic stay to enforce the setoff.

Second, in the Ninth Circuit, which includes California, banks without setoff rights are still permitted to freeze debtor accounts at least until the passage of the deadline for parties to object to the debtor's claim of exemption as to the account funds. *See In re Mwangi*, 764 F.3d 1168 (9th Cir. 2014). Nonetheless, a prudent bank in California may still want to heed the warnings of *Weidenbenner* and adjust its policies accordingly, especially because freezing a debtor's account is not mandated by the Bankruptcy Code.

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