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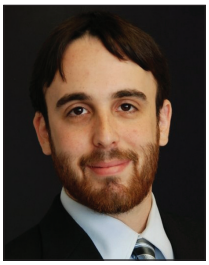
Feature

By Michael R. Herz

An Accelerating Thaw

Revisiting the Legality of Administrative Bank Freezes



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An article in the November 2010 *Journal* addressed the policy of certain financial institutions, most notably Wells Fargo, of automatically freezing the bank accounts of consumer debtors.[1] While banks such as Wells Fargo had employed the policy for years, likely consternating countless debtors, case law had been sparse until the Ninth Circuit Bankruptcy Appellate Panel (BAP) issued its opinion in *In re Mwangi* in June 2010.[2] *Mwangi* spurred a series of decisions from various courts, largely repudiating the Ninth Circuit BAP's logic in *Mwangi*. Consequently, any comfort that consumer debtors may have drawn from *Mwangi* has been greatly disquieted. Given the stream of post-*Mwangi* opinions, this article takes an updated look at the issue of administrative freezes, including in a chapter 11 context.

A Look Back

To refresh (or for those unfamiliar), certain financial institutions have implemented policies whereby they automatically freeze a debtor's bank accounts upon learning of that debtor's bankruptcy filing, irrespective of whether a debtor has claimed any exemptions in the funds. In instances involving Wells Fargo, the bank typically issues a letter to the debtor explaining that the accounts have been frozen in accordance with §§ 541 and 542 of the Bankruptcy Code, and another letter to the debtor's trustee requesting direction as to the disposition of the impounded funds. The funds will lie in stasis until the trustee instructs otherwise, potentially remaining frozen for weeks until the trustee has had opportunity to question the debtor at the meeting of creditors.

At this juncture, there are a number of competing practical concerns. On one hand, a freeze may function as an important device in preserving estate assets and circumventing potential discharge complications, particularly in instances where debtors have been less than forthcoming with respect to account balances. This was evident in *Mwangi*, as the freeze revealed an account balance substantially larger than what was initially disclosed by the debtors in their petition.[3] On the other hand, a freeze may serve as an overly cumbersome impediment imposed by a third party, potentially complicating a debtor's ability to manage vital expenses (*i.e.*, housing, food, health care, child care, etc.) while awaiting the trustee to act. In this vein, debtors have sought to sanction banks under § 362(k) for willfully violating the automatic stay.

Courts that have addressed administrative freezes have been guided by the U.S. Supreme Court's holding in *Citizens Bank of Maryland v. Strumpf*, which determined that a creditor can impose an administrative freeze to preserve the *status quo* while seeking relief from the automatic stay to enforce a right of setoff.[4] A key element of the decision is the finding that a bank account constitutes a promise by the bank to pay the depositor, rather than tangible property, and thus a temporary refusal to pay, such as through an administrative freeze, only amounts to a broken promise rather than an assumption of control over property. In the context of a chapter 7 filing, the trustee assumes the place of the depositor/debtor and § 542(b) requires that a bank's obligation to pay on an account be made to the trustee upon demand or order. Resultantly, no duty is owed by the bank to the debtor.

Although the Supreme Court limited its ruling to the context of setoff,[5] the opinion had been extrapo-

1 Michael R. Herz, "Automatic Bank Freezes: Protecting Estate Assets or Impeding Consumer Debtors' Rights?," XXIX *ABI Journal* 9; 1, 60-62; November 2010.
2 *Mwangi v. Wells Fargo Bank NA (In re Mwangi)*, 432 B.R. 812 (9th Cir. B.A.P. 2010).
3 The debtors originally disclosed just $1,300 in bank accounts, but the freeze revealed $17,075.06 spread over four accounts.
4 *Citizens Bank of Md. v. Strumpf (Strumpf)*, 516 U.S. 16 (1995). The Supreme Court's logic is grounded in § 553's right of setoff and § 542(b)'s exception to turnover for property that may be offset.
5 *Strumpf* at 19.

lated to administrative freezes imposed without setoff considerations by the few courts that addressed the issue prior to *Mwangi*.[6] The crux of these decisions rested on a finding that upon filing for bankruptcy, consumer debtors lack standing to challenge administrative freezes because they lack a property interest in the funds from which they could suffer an actual injury by a freeze. These courts observed that any injury stemming from a freeze is inflicted upon the estate, with the appointed trustee endowed with the exclusive authority to bring claims on behalf of the estate.

However, the Ninth Circuit BAP in *Mwangi* determined that in claiming an exemption in bank account funds, a debtor was manifested with an inchoate interest in the funds sufficient to have standing to challenge a freeze as violating the automatic stay. In reaching its conclusions, the BAP stressed that it viewed *Strumpf* as inapplicable when an administrative freeze is not implemented to preserve setoff rights.[7] While the BAP's ruling left room for interpretation, the decision seemed fueled by a strident disapproval of the policy itself, characterizing it as an extra-judicial process erected by a third party that went beyond the express turnover directives of § 542 and instead exercised control over estate property in violation of the automatic stay under § 362(a)(3).[8]

Post-*Mwangi* Developments

The cases that have spawned in the wake of *Mwangi*[9] suggest that the case may be the lone ship on its course. These decisions, some of which are overtly critical of *Mwangi*, have permitted administrative freezes through either (or both) of two rationales emanating from *Strumpf*. The first is that the imposition of an administrative freeze, rather than "paying over" as required by § 542(b), was merely a broken promise rather than an exercise of control over estate property, thereby not implicating the automatic stay provisions.[10] Harkening back to the few pre-*Mwangi* opinions, the second—and more commonly adopted basis—is that even if bank account funds constitute tangible property that a bank can exert control over through an administrative freeze, debtors lack standing to pursue sanctions for a violation of the automatic stay.[11] In this respect, courts have read *Strumpf* in conjunction with the Supreme Court's holding in *Schwab v. Reilly* that exemptions represent attempts by the debtor to reclaim assets from the estate.[12] Essentially, since exempt property remains within the estate for a time, debtors already lack a right of access to funds that might be frozen and thus are not affected by a freeze.[13] In reaching this conclusion, courts have explicitly rejected *Mwangi* and the notion that an inchoate interest derived from a claimed exemption could imbue a debtor with standing.[14]

Even the courts that have adjudicated *Mwangi* on remand have not been persuaded by the BAP's conclusions. Notably, the *Mwangi* debtors, likely encouraged by the BAP's ruling, initiated a class action against Wells Fargo to force an end to the bank's administrative freeze practice.[15] In dismissing the action, the bankruptcy court elaborated that given the unmatured nature of an inchoate interest, the debtors did not have a present right to possession of the funds such that they could suffer an actual injury during the freeze, and thus lacked standing to assert an automatic stay violation.[16] The court referenced the closing sentence of the BAP's decision, stating that the debtors "have standing to seek sanctions… for willful violation of the stay with respect to *their interest* in estate property," and opined that if the debtors' interest is an inchoate interest as the BAP held, that interest is empty so long as the funds remain part of the estate.[17] The district court affirmed the dismissal, adding that even if the freeze persisted after the exempt funds revested in the debtors, the debtors would still lack standing to assert a violation of the automatic stay because the freeze would no longer apply to property of the estate.[18] The district court further noted that even if the debtors had standing, they would lack the authority to pursue turnover of the funds under § 542.

While the recent *Mwangi* decisions are aligned with the rising consensus, they also appear to be a direct departure from their parent panel, which explicitly held that the debtors had standing to assert a violation of the automatic stay and gave remand instructions to determine whether Wells Fargo committed a willful violation of the automatic stay through assessing the reasonableness of the administrative freeze.[19] Additionally, the tone of the BAP's opinion, infused with a strong disapprobation of Wells Fargo's policy, might suggest that the bankruptcy and district courts did not follow the intended import of *Mwangi*. Indeed, the lower courts seemed aware that they were treading on unsettled ground as their opinions contain a number of qualifications acknowledging the possibility of diversions from the BAP. The matter is once again pending appeal before the Ninth Circuit BAP,[20] and it will be interesting to see how the BAP reacts not only to the seemingly contravening opinions of the lower courts, but also to the emerging unanimity from outside the circuit.

Chapter 11 Ramifications

In addition to the impact on consumer debtors, there has also been some discussion on the implications of administrative freezes within the context of chapter 11 filings. In *In re Randolph Towers Cooperative Inc.*,[21] Wachovia (now a part of Wells Fargo) implemented a "debit restraint" on a chapter 11 debtor's non-debtor-in-possession (DIP) accounts pending an order from the court allowing continued use of the accounts. Absent a court order, Wachovia advised that it would either issue a cashier's check payable to the DIP account or directly transfer the funds to the DIP account. The ostensible purpose of the restraint was to prevent the debtor

6 The most notable pre-*Mwangi* opinions include *Wells Fargo Bank NA v. Jimenez*, 406 B.R. 935 (D.N.M. 2008), and *Calvin v. Wells Fargo Bank NA*, 329 B.R. 589 (Bankr. S.D. Tex. 2005).
7 *Id.* at 820.
8 *In re Mwangi*, 432 B.R. at 823-24.
9 *See* Herz, XXIX *ABI Journal* 9, November 2010.
10 *See In re Randolph Towers Coop. Inc. (In re Randolph Towers)*, 458 B.R. 1 (Bankr. D.D.C. 2011); *In re Young*, 439 B.R. 211 (Bankr. M.D. Fla. 2010); *In re Phillips*, 443 B.R. 63 (Bankr. M.D.N.C. 2010).
11 *See Cook v. Wells Fargo Bank NA (In re Cook)*, 2012 WL 1356490 (10th Cir. B.A.P. April 19, 2012); *In re Bucchino*, 439 B.R. 761 (D.N.M. 2010); *In re Kessler*, 2011 WL 1042617 (Bankr. S.D. Cal. March 4, 2011); *In re Zavala*, 444 B.R. 181 (Bankr. E.D. Cal. Feb. 7, 2011); *In re Yang Sul Lee*, 2011 WL 5452830 (Bankr. D. Alaska March 15, 2011); *In re Young*, 439 B.R. 211.
12 *Schwab v. Reilly*, 130 S.Ct. 2652, 2663-64 (2010).
13 *See In re Bucchino*, 439 B.R. at 772.
14 *See In re Cook*, 2012 WL 1356490 at *8, and *In re Young*, 439 B.R. at 218.
15 *Mwangi v. Wells Fargo Bank NA*, Case No. 09-24057, Adv. Pro. No. 11-01022, *slip op.* (Bankr. D. Nev. July 26, 2011) (the "*Mwangi* Class-Action Opinion").
16 The bankruptcy court applied the same rationale in denying the debtor's motion for sanctions on remand from the BAP. *See* Transcript of Oral Argument and Opinion, *In re Mwangi*, Case No. 09-24057 (Bankr. D. Nev. Jan. 25, 2012), ECF No. 205.
17 *See Mwangi* Class-Action Opinion at 7.
18 *Mwangi v. Wells Fargo Bank NA*, Case No. 2:11-cv-01753, *slip. op.* (D. Nev. April 9, 2012); *but see In re Kessler* at *3 (observing that debtor would have colorable claim for sanctions if freeze persisted after funds revested in debtor).
19 *In re Mwangi*, 432 B.R. at 825.
20 *Mwangi v. Wells Fargo Bank NA*, case no. 12-16087 (9th Cir. B.A.P. May 8, 2012).
21 *In re Randolph Towers*, 458 B.R. 1.

from using non-DIP accounts to pay pre-petition debts. The debtor asserted that the restraint violated the automatic stay, but the bankruptcy court, applying *Strumpf* as other courts have done in chapter 7 cases, found that the restraint (and administrative freezes generally), while potentially in violation of the "payover" requirements of § 542(b), does not engender an automatic stay question but a breach-of-contract question to be pursued by the trustee or DIP.

In the recent case of *In re Tuscan Ranch Inc.*,[22] the Ninth Circuit BAP had an opportunity to extrapolate upon *Mwangi* within a chapter 11 context. In *Tuscan Ranch*, a corporate chapter 11 debtor asserted that the automatic stay was violated when its deposit accounts were frozen shortly after filing. Beyond the chapter 11 backdrop, the case further differed from *Mwangi* in that the financial institution had a demonstrable right of setoff. As such, the Ninth Circuit BAP did not dwell on the implications of its findings in *Mwangi*, opting instead to focus its analysis on applying *Strumpf* to uphold the freeze in light of the bank's right of setoff. Nonetheless, near the close of its opinion, the BAP offered an interesting summary of the circumstances of the case, stating that "the case before us concerns a corporate chapter 11 [DIP], with no eligible statutory exemptions, and a credit union with demonstrable setoff rights."[23] The fact that the BAP made a point to differentiate *Tuscan Ranch* from *Mwangi* based on the respective filing chapters raises the possible inference that the BAP may not extend the same protections from automatic freezes to chapter 11 debtors that it did for chapter 7 debtors in *Mwangi*.

The Tenth Circuit BAP has recently more definitively chimed in on the case of *In re Cook*.[24] In a case that converted to chapter 7, the Tenth Circuit BAP noted that while a chapter 7 debtor, even with a claim of exemption, lacks standing to contest an administrative freeze, a chapter 11 DIP does have standing through assuming the role of the trustee in administering the estate.[25] As the Tenth Circuit BAP quipped, whether in chapter 7 or chapter 11, "a bankruptcy estate, like a ship, can have but one captain."[26]

Conclusion

In implementing administrative freezes, banks such as Wells Fargo may well be acting in furtherance of the aims of the Bankruptcy Code by preserving potential assets. What seems to have troubled the Ninth Circuit BAP, however, was that the bank unilaterally created a mechanism beyond the instruments provided in the Code for addressing property in which the bank had no interest.[27] It is a question of authority, and perhaps a fear of a slippery slope.While other courts have not necessarily approved of the freeze, they have effectively determined that there is little practical means to challenge the freeze in a chapter 7 case unless the appointed trustee is somehow compelled to do so and then able to demonstrate an injury to the estate. Moreover, it remains that the ultimate effect of a freeze may not differ much from a bank simply turning over an account consistent with the express language of § 542. While the concept of an administrative freeze may not sit well with many, it would appear that courts have erected strong foundations to countenance the practice, and debtors' attorneys should be mindful to counsel clients on the prospects of an administrative freeze, even with respect to exempted funds. abi

22 *Tuscan Ranch Inc. v. AEA Fed. Credit Union*, 2012 WL 603639 (9th Cir. B.A.P. 2012).
23 *Id.* at *6.
24 *See In re Cook*, 2012 WL 1356490.
25 *Id.* at *9. *See also In re Young*, 439 B.R. at 218-19 (observing that administrative freezes may well violate automatic stay in both chapter 11 and 13 cases).
26 *In re Cook* at *9.
27 This may be best illustrated in *Randolph Towers*, wherein Wachovia's policy goes so far as to determine how and when to close an account through issuing a cashier's check made payable to a recipient designated by the bank.

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