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Bankruptcy Court Punishes Bank for Taking Pro-Active Measures to Protect Estate Property

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In this article, the authors analyze a New Mexico bankruptcy court decision which addressed the retail bank practice of searching the bankruptcy court docket to ascertain whether any of its account holders have filed for bankruptcy, and, if so, inquiring of the trustee as to whether the monies are part of the estate. In this case, the court held that such proactive measures violated the automatic stay.

Some retail banks maintain a policy of periodically searching the electronic bankruptcy court docket systems to determine whether any of their account holders have filed bankruptcy. Once the bank has ascertained that an account holder has filed for bankruptcy, it places an administrative freeze on the funds in the holder's accounts, notifies the Chapter 7 trustee, and requests a determination from the trustee as to whether the funds are part of the estate. If so, the bank inquires as to whether the monies should be turned over to the trustee, or released to the debtor. While Section 542 of the Bankruptcy Code requires a creditor to turn over estate property to the trustee, it provides a safe harbor to entities that do not have actual notice or knowledge of the bankruptcy proceeding, and it does not impose an obligation on an entity to take affirmative steps to determine whether their customers have sought

bankruptcy protection. Banks with many branch offices, however, often take these steps as a precautionary measure to protect against situations where they may have received technical notice of a filing, but such notice has not yet been routed to the appropriate authority at the bank. Recently, a New Mexico bankruptcy court ruled that these proactive measures constituted a violation of the automatic stay.

*In Re Jimenez*¹

On July 8, 2005, by searching the electronic docket, Wells Fargo received notice that Pilar Jimenez, one of its account holders, had commenced a Chapter 7 bankruptcy proceeding. Wells Fargo immediately placed an administrative freeze on the funds in Jimenez's accounts, and contacted the trustee for instructions on how to proceed. Wells Fargo also sent letters to Jimenez's attorneys, who promptly notified Wells Fargo that Jimenez was claiming the funds in the accounts as exempt. On July 14, the trustee authorized Wells Fargo to release \$4000 of the funds to Jimenez, which it did. Jimenez then sued Wells Fargo for turnover of the remaining funds subject to the administrative freeze, and for damages for, among other things, willful violation of the automatic stay. Jimenez claimed that



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Wells Fargo had no right to exercise control over the accounts. Wells Fargo claimed that it would have subjected itself to potential liability to the debtor's creditors if it did not do so.

McFadden v. Wells Fargo Bank

We are aware of two other recent cases in which Wells Fargo was sued by debtors under similar circumstances. In *McFadden v. Wells Fargo Bank*,² it appears from the court record that the trustee never responded to Wells Fargo's inquiry about what to do with the frozen funds. In that case, the debtor also claimed the funds in its accounts to be exempt. That court sympathized with Wells Fargo's reluctance to turn the funds over to the debtor absent written authorization from the trustee or an order from the court. The court further noted that, Wells Fargo would have been liable if it had turned the funds over to the debtor, and the debtor's exemption was later denied. The court then agreed to issue an order requiring Wells Fargo to release the funds to the debtor, but denied the debtors motion to find Wells Fargo in contempt for violation of the automatic stay.

In Re Calvin

*Calvin v. Wells Fargo Bank (In re Calvin)*³ also involved a dispute where Wells Fargo had frozen the funds of an account holder who had recently filed for bankruptcy. In *Calvin*, the court found that, since a bank account constitutes an obligation of the bank payable to the account holder, and such account becomes property of the estate upon a filing for bankruptcy, Wells Fargo was required, under Section 542(b) of the Bankruptcy Code, to "(a) immediately pay the funds in the account to the Trustee; or (b) if not immediately, then on the order of the Trustee." The *Calvin* court further relied on the Supreme Court's decision in *Citizens Bank of Maryland v. Strumpf*,⁴ which held that an administrative freeze on an account does not violate the automatic stay, because a bank account does not consist "of money belonging to the depositor and held by the bank [but instead,] consists of nothing more or less than a promise to pay...and [the bank's] temporary refusal to pay was neither a

taking of possession of respondent's property nor an exercising of control over it, but merely a refusal to perform its promise."

Although the *Strumpf* case dealt with a bank that placed a temporary freeze on the debtor's account pending court resolution of its right of setoff against the debtor, the *Calvin* court reasoned that Wells Fargo's temporary freeze on the accounts pending instruction from the trustee was comparable with the bank's actions in *Strumpf*. The court further noted that, even if Wells Fargo did violate the automatic stay, the debtor did not yet have standing to complain. Upon filing bankruptcy, the debtor's property vested in the trustee. Even though the debtor claimed the funds in the Wells Fargo account as exempt, those funds would not vest back to the debtor until the end of the 30 day period, during which creditors have the right to object to such claim of exemption.

During the trial, Wells Fargo presented two other previously decided cases in support of its argument that placing an administrative freeze on the accounts, was not an exercise of control over the debtor's property, but merely preserved the status quo pending a determination as to whether it would be required to turn the funds over to the trustee.⁵ In each of these cases the courts found that the banks, which were not attempting to exercise a right of setoff, were not in violation of the automatic stay because they were "acting in good faith to preserve the status quo, for the benefit of all creditors, pending verification as to whether the deposited funds were deemed property of the estate, or exempt property."

The Court's Holding

However, the *Jimenez* court found all of these cases to be unpersuasive. Further, the court determined that the Supreme Court's holding in *Strumpf*, was "limited to characterizing a freeze as a setoff, and therefore its characterization of a bank account as a "promise to pay" as opposed to actual property of the estate was only dicta and not binding upon lower courts. The *Jimenez* court instead relied on the holding in *In re Flynn*,⁶ a case which the court notes was decided two months after *Pimental*. The *Flynn* case, however involved different facts. In that case, the bank placed

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an administrative freeze on the debtor's account after learning of her bankruptcy filing, but not for the same reasons as Wells Fargo. In *Flynn*, the debtor also owed money on a loan from the bank. After placing the administrative freeze on the account, the bank telephoned the debtor (instead of her attorney) to inform her of the freeze and offered various options on how she could deal with her loan, none of which included not repaying it. The court in *Flynn* did find that the bank violated the automatic stay. However, it also noted that it was not addressing the same issue as it did in *Pimental*.

In response to Wells Fargo's argument that it was required to turn the funds over to the trustee pursuant to Section 542(b), the court noted the safe harbor provided by Section 542(c) for the unintentional failure to turn over funds, which applies to entities with no actual notice or knowledge of the bankruptcy case. While the *Jimenez* court did agree that "Wells Fargo must comply with the turnover provision if it acquires actual knowledge of the bankruptcy," it determined that Wells Fargo's policy was unnecessary to protect itself from Section 542 liability because it was not on the court's list of parties to receive official notice, and therefore wouldn't have received any notice if it did not go looking for it. The court then noted its belief that Wells Fargo created the obligation to the trustee in an effort to earn interest on the funds in the account during the temporary freeze, and not for the purpose of complying with Section 542(b). However, it is far more likely that the reason Wells Fargo searches the electronic docket for bankruptcy filings, instead of only relying upon actual service, is out of a concern that service could be made upon Wells Fargo at a variety of locations, and liability might result from

disbursements made after receiving official notice of a filing, but prior to the time that the appropriate persons at the bank are notified of the filing.

Although the court found Wells Fargo to have violated the automatic stay, damages have not yet been determined. Wells Fargo has filed a motion seeking permission to file an interlocutory appeal. If that motion fails, the bank will file an appeal through the normal appeals process. This decision appears to be an outlier, but if it withstands appeal, it will become cause for concern for banks with large retail operations.

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- 1 *Jimenez v. Wells Fargo (In re Jimenez)*, 335 B.R. 450 (Bankr. D.N.M. 2005).
- 2 No. 05-15072 (Bankr. W.D. Wash. July 29, 2005).
- 3 329 B.R. 589 (Bankr. S.D. Tex. 2005).
- 4 516 US 16(1995).
- 5 *In re Pimental*, 142 B.R. 26, 29 (Bankr. D.R.I. 1992) and *Sousa v. Bank of Newport*, 170 B.R. 492, 494 (D.R.I. 1994).
- 6 143 B.R. 798 (Bankr. D.R.I. 1992).