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How a Setoff Right Led to a Creditor Fight

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A recent decision from the North Carolina Court of Appeals teaches a valuable lesson about how a creditor with the upper hand against another creditor should behave to avoid squandering its advantage and becoming mired in litigation.

The decision involves a fight between two creditors. In one corner: a depository bank with setoff rights. In the other corner: a judgment creditor with a garnishment order. The prize? Several hundred thousands of dollars in two bank accounts owned by a company that owed both creditors.

KLO Acquisition, LLC maintained an Operating Account and Cash Collateral Account at Chase Bank. Chase Bank had loaned KLO over $12 million, and KLO was in default. KLO had also been sued by Guy M. Turner (GMT) for breach of contract. GMT obtained an order of attachment, garnishment, and notice of levy from a North Carolina state court as to KLO's accounts at Chase Bank. GMT served Chase Bank with the garnishment order. In response, Chase Bank setoff the Cash Collateral Account, applying over $328,000 to its defaulted loans.

But Chase Bank neither setoff the Operating Account nor remitted the funds to GMT. Instead, it mailed GMT a form letter that read: "JPMORGAN CHASE BANK NA HAS TAKEN THE RIGHT OF SETOFF. FUNDS NOT AVAILABLE." But Chase Bank continued to allow the borrower access to the Operating Account, debiting nothing and allowing millions of dollars to pass through it despite the garnishment order.

Needless to say, GMT was not pleased. Chase Bank now had to pay lawyers not to collect money KLO owed them but to defend the lawsuit GMT filed against it. In the first round, a North Carolina trial court ruled for GMT against Chase Bank, awarding them over $209,000 (the balance in the Operating Account when Chase received the garnishment order and notice of levy). In the second round, the North Carolina Court of Appeals reversed, in a split decision, handing Chase Bank the victory. Now it appears the case is headed to the North Carolina Supreme Court for the rubber match.

This should have been a first-round knockout. Chase Bank, like every bank that offers deposit accounts, had a perfected security interest in the accounts. You perfect a security interest in accounts by control, and maintaining the account at your bank IS control. Chase Bank also had a deposit account agreement with KLO that granted it the right to set off the accounts upon loan default. As long as the Operating Account and Cash

Collateral Account were opened before GMT received its garnishment order (and they were), there was no way GMT could prevail over Chase Bank. Unless Chase Bank, through its conduct, waived its rights as the superior creditor.

And that is exactly what GMT argued -- Chase Bank waived its setoff rights by not enforcing them and allowing KLO unfettered access to the Operating Account for months after receiving the garnishment order. The trial court agreed with GMT's argument, but two members of the Court of Appeals determined that Chase Bank did not have to enforce its setoff rights to preserve them. It was enough to invoke them in the form letter they sent to GMT. In other words, a depository bank need not actually exercise its setoff rights so long as it asserts them to interpose its superior security interest against a creditor with a junior lien.

Chase Bank is victorious -- pending what happens at the North Carolina Supreme Court. But it has a permanent self-inflicted wound. It didn't have to be this way. Chase Bank could have set off the Operating Account and applied the funds to the defaulted loans. GMT could only watch. Chase Bank may have wanted KLO to use the Operating Account because it increased the likelihood they would generate revenue to pay off their loans. But if this was Chase Bank's objective, given the garnishment order, it needed to do more than send a form letter. Chase Bank should have engaged counsel to negotiate a three-party agreement with GMT and KLO that would preserve Chase Bank's rights and cutoff future litigation at inception. Perhaps each month, a percentage of funds could have gone to GMT, Chase, and KLO for operations. Chase Bank had all the leverage to propose a "take it or leave it" deal with GMT. If GMT refused, then Chase Bank could have set off the account. As much as Chase Bank may have wanted to work out the loan with KLO, if it knew it would be sued by GMT, it could have acted differently.

The narrow holding from the North Carolina Court of Appeals is that a mere assertion of setoff rights by a depository bank will preserve the right, even without actual enforcement. But the larger lesson of this ongoing saga is that creditors must exercise more caution and care when challenged by another creditor desperate to collect from the same borrower.

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