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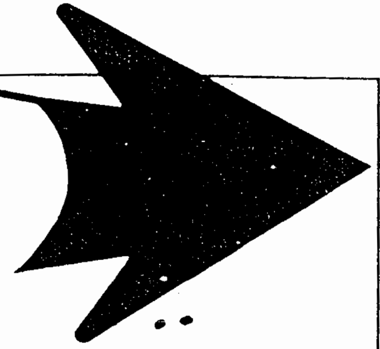

BANKERS BEWARE – GARNISHMENT LAW UP IN AIR

Garnishment of a debtor's bank account is a favorite tool of collection attorneys. Historically, when counsel for a judgment creditor received back a response from a bank to the effect that "no funds" were owed to the defendant by the bank, it has not necessarily meant that the creditor's counsel garnished the wrong account. Such an answer from the defendant's bank in the past may have simply meant that the bank, upon receipt of the garnishment, exercised its common law right of setoff and applied any funds in the account at the time to the debtor's outstanding loan obligations to the bank.

After all, the common law right of setoff is based upon mutuality of obligation. Any funds on deposit are owed by the bank to its depositor, and the depositor in turn frequently has an outstanding obligation to the bank. From the bank's point of view, it would make no sense for it to have to apply the debtor's liquid assets- -over which the bank exercises possession and dominion- -to an obligation its depositor owes to a mere judgment creditor.

Suppose, however, that upon receipt of a garnishment, the bank merely responds "no funds" without actually exercising its right of setoff. Suppose that the bank instead merely "freezes" the debtor's account, yet goes on to honor those checks drawn on the account which the bank somehow deems worthy of honoring over the garnishment.

These are essentially the facts as they are presented in Ferguson Enterprises, Inc. v. Main Supply, Inc., 40 K.L.S.3, pg. 4, which the Kentucky Court of Appeals decided on February 19, 1993.

Ferguson, a judgment creditor, garnished Main Supply, Inc.'s bank account at Bank of Danville, which at the time of receipt of the garnishment by the bank had $13,206.87 available. Although the bank provided an affidavit and answer to the effect that there were "no funds", the bank deemed a loan to Main Supply as being in default, thus entitling it to the account balance by reason of either a security lien interest or setoff.

Based upon rather puzzling reasoning, the Court first held that the bank could not hold a security interest in the funds in a debtor's account under the Uniform Commercial Code, but did have a right to setoff. The Court then looked to UCC 4-303 (KRS 355.44-303) for the following

language:

> (1) Any knowledge, notice or stop-order received by, legal process served upon or setoff exercised by a payor Bank, whether or not effective under rules of law to terminate, suspend, or modify the bank's right or duty to pay an item or to charge its customer's account for the item, comes too late to so terminate, suspend or modify such right or duty if the knowledge, notice, stop-order or legal process is received or served and a reasonable time for the Bank to act thereon expires or the setoff is exercised after the Bank has done any of the following:
>
> (a) Accepted or certified the item [.]

The Court therefore reasoned that the Bank cannot charge a customer's account with a setoff after accepting a garnishment thereon, and so the real issue was what was first in time, the bank's acceptance of the garnishment or the bank's exercise of its right of setoff.

Based upon prior law, the Court found three (3) steps necessary for a setoff to be completed:

(1) The decision to exercise the right,

(2) Some action which accomplishes the setoff and

(3) Some record which evidences that the right of setoff has been exercised.

The Court also accepted the concept from prior law that the exercise of setoff should somehow have to be recorded as a bookkeeping entry, and specifically held that the bank has the burden of proof as to when setoff actually occurs, as evidenced by intent, affirmative acts, and some record that the right of setoff has been exercised.

Although the bank contended that the account had been "frozen" prior to receipt of the garnishment, the evidence indicated that at least four (4) withdrawals from the account had been allowed after the "freezing" of the account. There was even evidence to suggest that the loan was not even considered to be in default by the bank until after receipt of the garnishment. The Court concluded that there could not have been an intention to setoff the account prior to the garnishment.

Since Ferguson's garnishment lien had priority, due to its being first in time, Ferguson was entitled to $13,206.86 to be paid over to it by the bank.

On May 13, 1992, a Petition for Discretionary Review by the Kentucky Supreme Court was filed, and so the opinion rendered by the Court of Appeals is not yet final and cannot be used as precedent in the Courts of the Commonwealth. Your editor represents both judgment creditors and banks in garnishment situations. It is your editor's belief that although the Bank of Danville did not properly exercise its right of setoff under the facts of the case decided, the Court of Appeals decision is too far-reaching in stating that a bank cannot have priority as to its setoff rights once it has "accepted" a garnishment. It is only common sense that a bank should not have to pay out funds in its possession to a third party when its depositor is in default to the bank. A bank should, however, upon a response of "no funds" to the garnishment actually have to setoff whatever funds are in the account and apply them to the depositor's obligation to the bank.

The Court of Appeals decision as it presently stands would suggest that banks would be smart to set up procedures whereby they preserve their right to setoff in order to exercise it prior to "accepting" the garnishment of a judgment creditor. For example, a bank could delay stamping an acceptance date upon any garnishment until such time as it checks the status of its customer's obligation to it and has a chance to setoff the account. *The Arrow* intends to monitor what happens to the Petition for Discretionary Review and will report to readers on what the Kentucky Supreme Court does. ❑

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