

Financial Services Litigation

ALERT

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PERFECTED SECURITY INTERESTS VS. WRITS OF GARNISHMENT: THE BATTLE CONTINUES

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Consider this scenario: The Widget Manufacturing Company asks its primary bank, Main Street Bank, to lend Widget \$1 million to modernize the equipment at its widget plant. Main Street agrees to do so and the parties enter into loan and security agreements under which Widget grants Main Street a security interest in Widget's bank account at Main Street in order to secure repayment of the debt. A few weeks later, Doodad Supply Company sues Widget for failing to pay Doodad \$500,000 under a supply contract between Doodad and Widget. Doodad eventually obtains a state-court judgment against Widget and then serves a writ of garnishment on Main Street, seeking to obtain the funds in Widget's bank account at Main Street as payment for its judgment. Main Street responds that, while there is \$500,000 in the bank account at the time the writ is served on it, Main Street's perfected security interest in the bank account trumps Doodad's judgment lien. Thus, Main Street refuses to seize the funds in the account for Doodad's benefit. However, Main Street also does not seize the \$500,000 for its own benefit (to pay down the debt Widget owes the bank). Instead, Main Street allows Widget to continue drawing on the funds in the bank account in order to operate its business. Has Main Street acted wrongfully? Can it defy the writ of garnishment obtained by Doodad? And if its initial response of refusing to honor the writ was proper, did it act wrongfully when it then allowed Widget to use the sought-after funds to operate its business?

Article 9 of the Uniform Commercial Code (UCC) would appear to favor the bank in the above scenario, authorizing it to both turn back the judgment creditor's attempted garnishment and allow its debtor to continue operating its business with the funds in its bank account. Yet, a number of courts have recently held otherwise, finding the bank liable in this situation for

refusing to turn over the funds in the bank account to the garnishing judgment creditor. In light of these developments, banks should be cautious in exercising their rights as holders of perfected security interests when confronted with garnishment orders from judgment creditors of their account holders.

Under Article 9, a security interest in a debtor's property is enforceable if (1) the secured party gave value for the security interest; (2) the debtor had rights in the property; and (3) where the property is a bank account, the secured party has "control" of the bank account. When the secured party is the bank with which the bank account is maintained, the bank has "control" of the account. Thus, whenever a bank lends money to a customer and, in exchange, takes a security interest in the customer's account at the bank, the bank has an enforceable security interest in that bank account. Under Article 9, however, all security interests are not created equal. Rather, *perfected* security interests generally are favored over *unperfected* security interests. The steps required for perfecting a security interest vary depending on the type of property at issue. For bank accounts, a security interest is perfected by control. Thus, a bank's enforceable security interest in its customer's account at the bank is automatically perfected.

In seeking payment of a debt, multiple creditors, including banks and judgment creditors, frequently fight over the right to seize a debtor's property to repay the debt. The heart of Article 9 is its detailed set of priority rules for sorting out who gets first dibs on such property. Under Section 317, a judgment creditor's claim to a debtor's property has priority over a secured party's claim *unless* the secured party perfected its security interest before the judgment creditor obtained its lien. Thus, by its plain terms, when a bank has a security interest in its customer's account (which, by

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definition, is perfected), that interest trumps the claim of a judgment creditor who obtained its judgment after the bank obtained its security interest in the account. In addition, the bank need not freeze its customer's account simply because a competing creditor seeks to attach that bank account. Rather, Section 205 provides that a security interest is not "invalid" against creditors simply because the debtor is allowed to use its property that is subject to the security interest. Moreover, under Section 332, the security interest in a bank account does not tag along with the transfer of funds from the account. Thus, recipients of funds from the debtor's bank account can accept such funds as payment for goods or services without concern that, by doing so, they are subjecting themselves to claims of the debtor's secured creditors.

These rules make a great deal of sense. A creditor with a perfected security interest in its debtor's bank account might not want to risk forcing its debtor out of business by seizure of its funds or freezing of its bank accounts. Rather, in order to make collection of its entire loan more probable, the bank might prefer that the debtor use its property to operate its business with the funds in its bank account. Similarly, third parties dealing with the debtor may be reluctant to accept funds from a bank account subject to a perfected security interest if the bank or another creditor could stake a claim to those funds as a result of their security interest.

Yet, despite these eminently reasonable rules — and the plain language of the UCC — a number of courts have held that a party with a perfected security interest must nonetheless honor a writ of garnishment if it does not "exercise" its perfected security interest by seizing the secured property for

itself. Put another way, these courts hold that a party such as a bank "waives" its perfected security interest in its debtor's property if it does not take steps to seize the property upon receipt of a writ of garnishment. *See, e.g., C & H Sugar Co. v. Solstice Indus.*, 2006 U.S. Dist. LEXIS 56605, at *20-*25 (E.D. Mich. Aug. 14, 2006), *vacated on other grounds*, 2007 U.S. Dist. LEXIS 71830 (E.D. Mich. Sept. 27, 2007); *R.C. Moore, Inc. v. Les-Care Kitchens, Inc.*, 913 A.2d 1081, 1086 (Me. 2007) (rejecting bank's security interest argument and noting, in dicta, that the bank had not declared the debtor in default and had "allowed funds to leave the . . . account").

In light of these recent rulings, what is a bank to do when it receives a writ of garnishment for one of its customer's bank accounts in which the bank has a perfected security interest? Unfortunately, the answer is not clear. If the bank would prefer to keep its debtor in business and not declare it in default and seize the funds in its bank account, it risks a ruling that it improperly failed to turn over funds to a judgment creditor. Yet, the alternative path — turning over the funds in the account to the garnishing creditor — requires the bank to subordinate its own perfected security interest and concomitantly reduce the funds available to its debtor to either operate its business or pay the bank back its loan. Perhaps the best thing the bank can do is act quickly to respond to the garnishment writ, filing a response in the court from which the writ issued and asserting its rights under Article 9 as a perfected security interest holder with an express priority over the claim of the later-arriving judgment creditor. At that point, if the court interprets Article 9 correctly, it will quickly rule that the bank is entitled to reject the attempted garnishment and allow its debtor to continue accessing the funds in its bank account to operate its business. ♦

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