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A Bank's Policy to Freeze a Debtor's Bank Account Upon Commencement of a Chapter 7 Bankruptcy Case Violated the Bankruptcy Automatic Stay

A national bank had a nationwide policy to place an administrative freeze on a debtor's bank account upon receipt of notice of commencement of a chapter 7 bankruptcy case and to continue the freeze until it received instructions from the chapter 7 trustee regarding disposition of the funds in the account. In *In re Mwangi*, Case No. 09-1408 (9th Cir. B.A.P., June 30, 2010), the Ninth Circuit Bankruptcy Appellate Panel (the "BAP") held that this policy violated the automatic stay provision of the Bankruptcy Code and subjected the bank to possible sanctions for violation of the automatic stay.

Facts

Mr. Mwangi and his wife filed a joint voluntary petition for relief under chapter 7 of the Bankruptcy Code thereby commencing a personal chapter 7 bankruptcy case. When the bank learned of the bankruptcy case, the bank placed a temporary administrative freeze on the debtors' bank accounts and sent a letter to the chapter 7 trustee, with a copy to the debtors, asking the trustee for instructions on what it should do with the funds in the accounts, all in compliance with its nationwide policy. The debtors claimed seventy-five percent of the funds in the accounts were exempt in their bankruptcy case and made demand on the bank for turnover of those funds. The bank refused to turnover the funds to the debtors while it waited for instructions from the chapter 7 trustee, which never came. The debtors then filed a motion seeking sanctions against the bank for violation of the automatic stay provision of 11 U.S.C. section 362(a) for refusing to turnover their exempt funds. Although the debtors scheduled the bank as an unsecured creditor in their bankruptcy case, the bank did not assert a banker's right of setoff against the funds in the debtors' bank accounts.

Analysis

In its analysis, the BAP recognized that the Supreme Court decision, *Citizens Bank of Maryland v. Strumpf*, 516 U.S.16 (1995) holds that a bank's temporary administrative freeze of a chapter 7 debtor's bank account to protect the bank's right of setoff is permissible. However, the BAP distinguished the facts of this case from those of *Strumpf* because in this case the bank did not assert its right of setoff. The BAP pointed out that *Strumpf* does not hold that a temporary administrative freeze on a debtor's bank account cannot violate the automatic stay. The BAP held that the debtors had standing to pursue the bank for sanctions for violation of the automatic stay. Finally, the BAP held that the bank violated the automatic stay by exercising control over the funds in the debtors' bank accounts when it froze the accounts and would not release the funds. The BAP remanded the matter to the bankruptcy court to determine whether the bank's actions were reasonable under the circumstances and if not, then what, if any, damages the debtors should receive.

While this case recognizes a bank's legal right to place a temporary administrative freeze on a debtor's bank account to preserve and protect a bank's right of setoff against funds in the account, it also points out the potential pitfalls of an inflexible administrative freeze policy. The attorneys at KMTG are available to provide guidance on bank administrative freeze policies and assistance when a demand is made by a debtor or a bankruptcy trustee for turnover of funds in a debtor's bank account.

Questions

If you have any questions concerning the content of this Legal Alert, please contact the following from our office, or the attorney with whom you normally consult.

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