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Secured Lender's Loss of Possessory Lien Affirmed

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The U.S. Bankruptcy Appellate Panel ("BAP") for the Eighth Circuit held on March 25, 2013, that a lender "lost its possessory lien when it turned the Debtor's account funds over to the Trustee without first seeking adequate protection." In re WEB2B Payment Solutions, Inc., __ B.R. 2013 __, 2013WL 1188041, *5 (8th Cir. B.A.P. March 25, 2013) (emphasis added). Affirming the bankruptcy court's granting of summary judgment to the trustee, the BAP stressed that "a possessory lien is, by definition, released when possession of the collateral is relinquished." Id. at *3.

Relevance

Trustees and Chapter 11 debtors in possession routinely ask secured lenders to turn over, if not to permit the use of, encumbered cash accounts — here, a cash deposit account encumbered by a contractual lien. The Bankruptcy Code ("Code") explicitly provides for mandatory "adequate protection" when a secured lender does not consent to the use of its collateral (§ 363(e)); or when a secured lender's lien will be primed (§ 364(d)). Code § 361 gives examples of "adequate protection," including "periodic cash payments" or "an additional or replacement lien." Secured lenders, for example, are entitled to be "adequately protected" against any erosion in the value of their collateral. United States Sav. Ass'n. v. Timbers of Inwood Forest Assocs., 484 U.S. 365, 370 (1988); "'Adequate protection' is a term of art in bankruptcy practice … ; in short, it is a payment, replacement lien, or other relief sufficient to protect the [secured] creditor against diminution in value of its collateral during the bankruptcy." In re SCOPAC, 624 F.3d 274, 278 n.1 (5th Cir. 2010).

A lender must ask for this protection, though. The WEB2B case shows how a lender's well-intentioned cooperation can backfire if it fails to seek adequate protection. As one commentator noted, a lender may be entitled to this protection "only from the time [it] makes the request" under Code § 363(e). 3 Collier on Bankruptcy ¶ 363.05[2], at 363-41 (16th ed. 2010), citing In re Keck, Mahin & Cate, 1999 U.S. Dist. LEXIS 5056 (N.D. Ill. Mar. 30, 1999).

Facts

The debtor provided check-clearing and payment-processing services for its customers. The debtor's retail customers would send the debtor checks which it would then deposit with the bank ("Bank") under a "Remote Deposit Capture Service Agreement" ("Agreement"). Id. at *1.

The Bank then immediately credited the debtor's account at the Bank for the full amount of the checks. Id. According to the Bank, when it received third-party claims rejecting particular checks received from the debtor, it was "entitled to recover the funds from the Debtor's accounts … " Id. The U.S. Treasury, for example, would make "chargeback claims" when fraudulent, counterfeit or forged Treasury checks had been presented to the debtor by its customers and then processed by the Bank. Id.

The Agreement: Security Interest and Setoff Rights

The Bank relied on provisions in the Agreement to claim "both a security interest in the Debtors' funds deposited with [it] and rights of setoff." Id. Specifically, the Agreement contained an assignment of "all of [the Debtor's] deposit accounts with [the Bank] … to secure its obligations … under this Agreement." Id. The Agreement also authorized the Bank "to debit any account maintained by [the Debtor] with [the Bank] … and/or set off any of [the Debtor's] obligations … under this Agreement against any amount it owes to [the Debtor] … " Id.

The Turnover

The Bank had "over $933,000 on deposit in its accounts" for the Debtor as of the date of bankruptcy. Despite the statutory automatic stay in effect when the Debtor filed its bankruptcy petition, the

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Bank later set off $27,180.54 "to cover an overdraft," and "froze the account shortly after the bankruptcy filing." Id. When the trustee asked the Bank to turn over the funds in the Debtor's accounts, the Bank proposed to "retain $50,000 of the funds (the 'Holdback Funds') to cover potential future reclamation requests." Id. This last "Holdback" calculation was based on the debtor's prior history of reclamation claims. Shortly thereafter, the Bank and the Trustee agreed on the terms of the Bank's proposal regarding the Holdback Funds and the earlier setoff, requiring the Bank to turn over the sum of $883,120.46 to the trustee. Most significant, the Bank "never asked the Court to order that the Trustee provide adequate protection for any lien it claimed on" the released funds. Id. In other words, the Bank never even suggested that the released funds remained subject to its lien.

The Bank's Attempted Clawback

"[A]n unanticipated and unprecedented volume and dollar amount of Treasury reclamations of tax refund checks" were processed by the Debtor and deposited in its accounts at the Bank shortly prior to bankruptcy. Id. at *2. Although the Bank set off these reclamation claims from the Holdback Funds, these funds were soon depleted, causing the Bank to tell the Trustee "that the reclamation claims … were significantly larger than anticipated," with a request "that a portion of the [released] funds be returned to … satisfy these claims." Id. The Bank asserted a lien on the funds it had turned over to the trustee, stating that it had already paid $512,457.39 "to satisfy the unanticipated reclamation funds," and demanding the return of the entire $883,120.46 previously turned over. Id.

The Bank sued the trustee nine months later, after he rejected its demand, seeking a declaratory judgment that it had a first lien on the funds turned over after bankruptcy. Both parties cross-moved for summary judgment, conceding the material facts. Id.

The Bank also conceded on appeal the first part of the bankruptcy court's adverse ruling that it had lost its contractual right of setoff when it turned the funds over to the trustee, "since there were no longer any funds in its possession to set off." Id. The Bank did dispute, however, the bankruptcy court's holding that the Bank had "lost its possessory lien in the funds" turned over because it had failed to first obtain a court order granting adequate protection of its possessory lien. Id.

Applicable State Law

Section 9-314(a) of the Minnesota version of the Uniform Commercial Code ("UCC") provides that "a security interest in … deposit accounts … may be perfected by control of the collateral under … Section 9-104 … " The filing of a UCC financing statement will not perfect a security interest in a deposit account. See UCC § 9-312(b)(1) ("security interest in a deposit account may be perfected only by control"). UCC § 9-104(a)(1) further provides that "[a] secured party has control of a deposit account if … the secured party is the bank with which the deposit account is maintained."

The Trustee conceded the Bank's contractual security interest in the account funds that "was perfected by possession as of the [bankruptcy] petition date." Id. Moreover, the Bank's "lien survived the bankruptcy filing itself." Id. The only issue was "the effect of the [Bank's] turnover" on its possessory lien. Id.

The Bank's Bankruptcy Argument

The Bank could not argue that its possessory lien had survived its turnover of the funds under applicable Minnesota law. Instead, it argued that the Code's turnover requirement and automatic stay provisions forced it to "turn over the funds to the Trustee." Id. at *3. Arguing that its lien was preserved because of the forced turnover, it relied on the Supreme Court's holding in U.S. v. Whiting Pools, Inc., 462 U.S. 198, 207 (1983) (held, secured creditor may be compelled under § 542 to turn over collateral in its possession, but if creditor has validly perfected security interest, it is entitled to "adequate protection" for its interest in turned over property; " … Code provides secured creditors various rights, including the right to adequate protection, and these rights replace the protection afforded by possession.").?The BAP distinguished Whiting Pools because that case turned on a statutory tax lien, not a contractual possessory lien like the one held by the Bank. With a federal tax lien, the property remains subject to the lien once the government files a notice and "follows the property of the taxpayer, no matter into whose hands the property goes." Western National Bank, Odessa, Tex. v. U.S., 812 F. Supp. 703, 705 (WD Tex. 1993). In contrast, the Bank's contractual lien on the proceeds in the debtor's deposit account here was "dependent on possession." Id. at *3.

The BAP heavily relied on the Supreme Court's decision in Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995), to confirm that a bank's right of setoff will be lost if it relinquishes possession of funds in the debtor's bank account. The Supreme Court unanimously held in Strumpf that the bank's "freeze" of the debtor's bank account was not a setoff, and thus did not violate the automatic stay contained in Code § 362(a)(7). In order not to lose its setoff rights, the bank in Strumpf had to freeze the account temporarily while it sought a modification of the stay under Code § 362(d) that would permit a setoff.

The critical fact in WEB2B was the Bank's holding of a possessory lien which, "by definition, released when possession of collateral was relinquished." Id. at *4. In other words, the Bank "voluntarily and affirmatively release[d] its lien by operation of law when it relinquished possession." Id. Unlike the secured lender in Whiting Pools, the Bank here had no nonpossessory statutory lien and no other lien "perfected by the filing of a UCC-1 … " Id. The Bank's possessory lien in account funds is essentially the same as a setoff right. As the BAP put it, "in either situation the creditor's rights in funds are lost when possession is given up." Id.

Whiting Pools and Strumpf "provide a roadmap for creditors whose rights in collateral will be relinquished with pos-

session," explained the BAP. Id. First, the lender "may withhold turning the collateral over until the bankruptcy court is able to make a determination as to" the creditor's entitlement "to adequate protection." Id. By following this procedure, the secured lender may "both comply with a trustee's demand for turnover of assets of the estate, as required by Whiting Pools, but at the same time preserve its possessory lien in the manner approved in Stumpf." Id.

In sum, the Bank could and should have asked the bankruptcy court for "an order providing that [its] lien continue in the proceeds being turned over." Id. Because the Bank never sought "adequate protection, and waited more than nine months before" seeking a court ruling as to the validity of its lien, it lost that lien. Id. Indeed, reasoned the BAP, given the Bank's prior setoff and its obtaining a $50,000 Holdback Fund, it believed there was "no need to hold back anything." Id. at *5.

Finally, the BAP rejected the Bank's argument that Code § 552(b)(1) (pre-bankruptcy lien insulates pre-bankruptcy collateral and its proceeds) protected its possessory lien. The funds here were not "proceeds, products, offspring, or profits" covered by § 552(b)(1), making the section inapplicable.

Comments

1) The Bank here could have done nothing more prior to bankruptcy under applicable state law (i.e., the Uniform Commercial Code) to protect its lien. Filing a UCC-1 financing statement would have been meaningless. UCC §§ 9-310(b)(8) and 9-312(b) provide that a security interest in a deposit account may only be perfected by control under UCC § 9-314. In short, the Bank simply misunderstood applicable bankruptcy law when it turned over the funds to the trustee.

2) As a practical matter, the trustee/debtor seeking to use cash collateral probably will need to offer a package of adequate protection to its existing secured lender, just as it will if it wants to give a priming lien to a new post-petition financing lender. Courts have, pursuant to Code § 361, approved adequate protection packages that provide secured lenders cash paydowns of principal, along with other protections, during the reorganization. See, e.g., Aurelius Capital Master, Ltd., v. Tousa, Inc., 2009 WL 6453077, *17 (S.D. Fla. 2009) (affirming consensual cash collateral order providing for cash payments to prepetition lenders by using excess cash on hand to repay portion of indebtedness, thereby reducing debtors' interest expense; held to be reasonable exercise of debtors' business judgment); In re Capmark Financial Group Inc., No. 09-13684, 11-14 (Bankr. D. Del. Dec. 22, 2009) (order authorizing adequate protection payments of current interest and principal to prepetition secured lenders).

In most cases, however, trustees/debtors seeking to use cash collateral are already short of unencumbered cash or other assets that may be converted into cash. As a result, periodic cash payments to the secured creditor are often not possible. Consequently, many trustees/debtors propose a combination of replacement liens on new post-petition assets and other forms of adequate protection for their use of cash collateral. To constitute adequate protection, however, the replacement liens must be on newly created, previously unencumbered proceeds from a sale of the debtor's assets. Resolution Trust Corp. v. Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.), 16 F.3d 552 (3d Cir. 1994) (en banc). In Swedeland, the Third Circuit held that "a continuing lien and security interest in and to all future sales proceeds and all other assets" did not adequately protect a secured lender who already had a lien on those post-petition proceeds. Id. at 565. Accord, Marcus Lee Assoc. L.P. v. Wachovia Bank. N.A. (In re Marcus Lee Assoc. L.P.), 2011 WL 206126 (E.D. Pa. Jan. 20, 2011).

3) Lenders should object at every opportunity in a bankruptcy case to the trustee/debtor's use of their collateral and seek "adequate protection" under Code § 361. See, e.g., In re California Webbing Industries, Inc., 2007 WL1953018 (Bankr. D.R.I. July 5, 2007) ("lender had, at every opportunity, stressed that it was not consenting to surcharge of its collateral for payment of professional fees"; "a clearer statement of a secured creditor's intention would be hard to find, and for this Court to conclude, on this record that [the lender] consented to a carve-out would last about as long on appeal as it would take the reviewing court to write REVERSED."; relevant cash collateral orders and stipulations required debtor to use lender's cash collateral to pay only necessary business operating expenses and monthly payments to lender.). See generally Cook, "Court Insulates Lender's Collateral From Professional Fee Surcharge," 3 Pratt's J. Bankr. L. 218 (2007).

4) Code § 363(e) explicitly provides that "at any time, on request of [a secured lender], the court … shall prohibit or condition … use, sale or leave as is necessary, to provide adequate protection." The Code's "plain language" thus confirms that "when a [lender] requests adequate protection, [it] will be granted to [it]. If no request is made, no protection is granted … Further, case law abounds in support of this reading … " In re Keck, Mahin & Cate, 1999 U.S. Dist. LEXIS 5056, *5 (N.D. Ill. March 30, 1999). In short, adequate protection is there for the asking.

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