THE BANK'S RIGHT OF SETOFF AND HOW IT AFFECTS YOU

By Jeff Schreiber*

Did you know that if you default on a bank loan, (whether it is a car loan, boat loan, personal loan or mortgage loan), the bank has a right without prior notice to you to take funds from your bank account(s) and apply them to the outstanding debt?
This is known as the right of setoff or a banker's lien. It has been recognized by the Indiana courts for over one hundred years. The right of setoff allows persons and entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A. Hence, the bank can exercise its right of setoff without notice to you and without your prior consent or direction.
This is how it works. When you deposit money in a bank account it becomes property of the bank. You become the bank's creditor to the extent of the deposit. Your bank account does not consist of your money sitting in the bank's vault. Rather it becomes the bank's promise to pay you. The bank's promise is usually guaranteed by the Federal Deposit Insurance Corporation ("FDIC"). When you borrow money from the same bank, a mutual debtor-creditor relationship arises that justifies the bank's right to setoff your bank account if you default on the bank loan. However, if you withdraw your money from that bank account, any mutual indebtedness is eliminated thereby thwarting the bank's ability to setoff the account.

The following is an example of how the right of setoff operates: You have a personal loan with Mega Bank and your checking account is with Mega Bank too. If you fall behind on your loan payment, Mega Bank, without notice to you or your prior approval, may take the money from your checking account to pay the loan without regard to any checks you have written against the funds you "thought" were on deposit!

There are limits to the bank's right of setoff. Special deposits, such as those deposited by a trustee in a trust account, cannot be applied by the bank for the payment of the general debts of the trustee. Funds deposited by a corporation may not be applied to pay personal debts of an officer of the corporation.

The bank's right of setoff even survives a bankruptcy. If you have read my past articles, you know that the minute a bankruptcy petition is filed, an automatic stay springs into effect, which prevents creditors from continuing any collection efforts. In C itizens Bank of Maryland v. Strumpf, 516 US 16 (1995), the United States Supreme Court recognized the bank's right to freeze a debtor's checking account. The bank refused to allow withdrawals from the account that would reduce the balance below the sum owed to the bank. Thereafter, the bank filed a motion with the bankruptcy court for permission to setoff money contained in the debtor's checking account. The debtor sought to have the bank held in contempt, claiming that the freeze violated the automatic stay. The Supreme Court sided with the bank. It ruled that a bank is permitted to freeze funds in a debtor's checking account so that it can timely request the court for relief to setoff the money. Thus, the debtor is prevented from cleaning out the account before the bank seeks a court Order.

Consequently, once the freeze is imposed, it is more likely than not that your money is lost to the creditor. The money is otherwise unrecoverable.

So what's the remedy? It is quite simple. If you are a consumer, and you are concerned about a bank's right to setoff your bank account, open another account in a different bank, one with which you have never done business, and one, obviously, to which you owe no money. Do not close the first account because you do not want to violate any covenants in your loan documents. Rather maintain a low balance in the original account. Open a new account in a different bank so that you can securely deposit your paycheck and other money and write checks against your deposits without the fear of a unilateral account freeze or bank setoff of funds without notice to you and without your prior consent.

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