

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF ALABAMA

In Re

BUBBA'S FOOD STORES, INC.,

Case No. 03-10974-MAM-11

Debtor.

**ORDER PARTIALLY GRANTING DEBTOR'S MOTION FOR TURNOVER AS TO
POSTPETITION DEPOSITS AND PARTIALLY GRANTING CREDITOR'S MOTION
FOR RELIEF FROM THE AUTOMATIC STAY TO EXERCISE ITS RIGHT OF
SETOFF AGAINST MONIES DEPOSITED FROM DECEMBER 11, 2002 THROUGH
FEBRUARY 18, 2003**

Irvin Grodsky, Mobile, Alabama, Attorney for Bubba's Food Stores, Inc.
J. Daniel Barlar, Jr., Mobile, Alabama, Attorney for Colonial Bank

This matter is before the Court on Bubba's Food Stores, Inc.'s ("BFS") motion for turnover of funds held by Colonial Bank ("Colonial") and Colonial's motion for relief from the automatic stay to allow it to setoff (or offset) a debt owed to it by BFS against funds Colonial is holding. The Court has jurisdiction to hear this matter pursuant to 28 U.S.C. §§157 and 1334 and the Order of Reference of the District Court. These matters are core proceedings pursuant to 28 U.S.C. §157(b)(2) and the Court has the authority to enter a final order. For the reasons indicated below, the Court finds that Bubba's Food Stores, Inc.'s motion for turnover is partially granted as to postpetition deposits and Colonial Bank's motion for relief from the automatic stay to exercise its right of setoff is partially granted as to monies deposited from December 11, 2002 through February 18, 2003.

FACTS

On February 18, 2003 when BFS filed a chapter 11 bankruptcy case in this Court, it had a commercial checking account with Colonial with a \$29,111.79 balance. BFS was also in default on two loan agreements with Colonial and owed Colonial \$479,044.35 as of January 3, 2003.

On June 28, 2002 BFS defaulted on both loans with Colonial by failing to make a payment. Compass Bank (“Compass”) obtained a judgment against BFS in the Circuit Court of Mobile County, Alabama on October 17, 2002 and served a garnishment on Colonial on December 11, 2002. Colonial denied BFS access to the funds in its account after the Compass garnishment was served and placed the account on administrative hold. Nonetheless, monies continued to be deposited into BFS’s account as credit card transactions involving BFS’s customers were automatically credited to its account.

Colonial answered the Compass garnishment on January 2, 2003 and paid \$6,812.42 out of the account at issue in this case into the circuit court on January 24, 2003 even though Colonial was holding \$17,715.08 in the account at that time.¹ The circuit court condemned the money and paid it to Compass. No evidence was presented to indicate that Compass was dissatisfied with Colonial’s answer or the amount of money Colonial paid into the circuit court. No court action was taken. After Colonial answered the Compass garnishment, additional monies were automatically deposited into BFS’s account, including \$2,413 after BFS filed its chapter 11 bankruptcy case. BFS and Compass now seek Court approval to access the balance in BFS’s account, which was \$29,111.79 as of the petition date.

BFS filed a motion for turnover of the funds in its Colonial checking account on March 12, 2003. Colonial filed an objection to BFS’s turnover motion and a motion for relief from the automatic stay to allow it to setoff the amount it claims it is owed by BFS under two loan agreements against the balance of BFS’s checking account. The Court held a hearing on both

¹ BFS filed a separate adversary proceeding complaint, Adv. No. 03-01090, against Compass on April 14, 2003 to recover the \$6,812.42 that Compass received from its garnishment action as a preferential transfer under 11 U.S.C. §547.

motions on April 22, 2003. BFS's account was still on administrative hold as of the hearing date.

BFS and Colonial disagree regarding whether Colonial has a right to setoff the amount it claims it is owed by BFS against BFS's checking account balance. BFS argues that it is entitled to the balance in its Colonial checking account because Compass had a garnishment lien against part of the funds that is an avoidable preference under 11 U.S.C. §547 and preserved for BFS under 11 U.S.C. §551. BFS alternatively argues that if the issue is controlled exclusively by 11 U.S.C. §553, then BFS can recover from Colonial any amount Colonial offsets postpetition that is greater than the amount Colonial could have offset 90 days before BFS's petition date under 11 U.S.C. §553(b). Finally, BFS argues that Colonial may not offset any amounts deposited into its Colonial checking account after it filed its chapter 11 bankruptcy case.

Colonial argues that the setoff issue is controlled exclusively by 11 U.S.C. §553, under which it was allowed to place a hold on BFS's account to protect its (Colonial's) position under the United States Supreme Court's decision in *Citizens Bank of Maryland v. Stumpf*, 516 U.S. 16 (1995). Colonial further argues that BFS cannot recover from Colonial any amount Colonial offsets postpetition that is greater than the amount Colonial could have offset 90 days before BFS's petition date because 11 U.S.C. §553(b) does not apply to postpetition setoffs.

LAW

The Court must consider the following issues to determine if Colonial has a right to setoff against BFS's checking account postpetition:

1. Did Colonial have a prepetition right of setoff against BFS's checking account under Alabama state law?

2. If Colonial did have a prepetition right of setoff against BFS's checking account under Alabama state law, did Colonial waive its right of setoff by failing to assert its setoff right against Compass, a garnishing creditor, in an earlier state court action?
3. If Colonial did not waive its prepetition right of setoff against BFS's checking account under Alabama state law, is its right of setoff preserved under 11 U.S.C. §553(a):
 - A. As to funds deposited into BFS's checking account from December 11, 2002 through February 18, 2003, the petition date?
 - B. As to funds deposited into BFS's checking account after February 18, 2003?
4. If Colonial's right of setoff against BFS's checking account is preserved under 11 U.S.C. §553(a), is it barred from exercising its right of setoff by one of the exceptions listed in 11 U.S.C. §§553(a)(1)-(3)?
5. If Colonial is not barred from exercising its right of setoff against BFS's checking account by §§553(a)(1)-(3), may BFS recover any amount of Colonial's setoff that is greater than the amount Colonial could have setoff 90 days before BFS filed its bankruptcy petition?

1.

Did Colonial Have a Prepetition Right of Setoff Against BFS's
Checking Account under Alabama State Law?

“The right of setoff (also called ‘offset’) allows 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.’” *Citizens Bank of Maryland v. Stumpf*, 516 U.S. 16, 18 (1995) (quoting *Studley v. Boylston Nat. Bank*, 229 U.S. 523, 528 (1913)). “Alabama recognizes the right to setoff.” *Atkinson v. Federal Deposit Ins. Corp.*, 635 F.2d 508, 510-11 (5th Cir. 1981) (citing to *King v. Porter*, 230 Ala. 112 (Ala. 1935)). Under Alabama law, “when a deposit is made to a bank account it becomes a debt to the customer; and, when the bank also loans money to the depositor, a mutual debt exists, and the bank may, when the loan matures, apply the money it

owes the depositor towards the depositor's debt to the bank." *In re Bryant*, Case No. 95-12471, Adv. No. 95-1257 (Bankr. S.D. Ala., January 7, 1997) (citing to *Rainsville Bank v. Willingham*, 485 So.2d 319 (Ala. 1986)).

In this case, Colonial had the right to setoff the amount of the defaulted loans against the balance of BFS's checking account under Alabama law because a mutual debt existed between Colonial and BFS. BFS opened a checking account at Colonial and subsequently entered into two loan agreements with Colonial. BFS defaulted on both loans, giving Colonial a state law right to setoff its debt to BFS against BFS's debt to Colonial. Colonial also had the right to setoff under its loan agreements with BFS.

2.

If Colonial Did Have a Prepetition Right of Setoff Against BFS's Checking Account Under Alabama State Law, Did Colonial Waive Its Right of Setoff by Failing to Assert Its Setoff Right Against Compass, a Garnishing Creditor, in an Earlier State Court Action?

Compass obtained a state circuit court judgment against BFS and served Colonial with a garnishment on BFS's checking account on December 11, 2002. Under Alabama Code §6-6-393, Colonial was required to file an answer to the garnishment within 30 days stating:

whether, at the time of the service of the garnishment, at the time of making his answer or at any time intervening between the time of serving the garnishment and making the answer he was indebted to the defendant and whether he will not be indebted in future to him by a contract then existing, whether by a contract then existing he is liable to him for the delivery of personal property or for the payment of money which may be discharged by the delivery of personal property or which is payable in personal property and whether he has not in his possession or under his control money or effects belonging to the defendant.

Colonial filed its answer on January 2, 2003 and paid \$6,812.43 from the account at issue in this case into the circuit court even though it was holding a larger amount, \$17,715.08, in the account as of that date.

Under Alabama Code §6-6-458, Compass was required to “controvert the answer of [Colonial] within 30 days after notice of the filing of the answer that [Compass] believes it to be untrue” if Compass was dissatisfied with Colonial’s answer or the amount of money paid into the circuit court by Colonial. No evidence was presented to indicate that Compass controverted Colonial’s answer and no court action was taken. The circuit court condemned the money and paid it to Compass, thereby discharging Colonial of any further obligation on the garnishment. *See Shepherd Motor Co. v. Henderson Land & Lumber Co.*, 104 So. 334, 336 (Ala. 1925) (lower court “did not error in discharging the garnishee on its amended answer . . . which the plaintiff did not controvert as the statute permits”).

When Colonial answered the Compass garnishment and paid \$6,812.43 from the account at issue in this case into the circuit court on January 2, 2003, Colonial waived its right to setoff against BFS’s account in the garnishment action. *National Bank of Boaz v. Royal Crown Bottling Co. of Boaz, Inc. (In re Royal Crown Bottling Co. of Boaz)*, 29 B.R. 52, 54 (Bankr. N.D. Ala. 1981) (holding that any right of setoff bank may have had under state law was waived when it paid money from debtor’s checking account to trustee). However, Colonial was discharged of any obligations in the garnishment action after the circuit court condemned the money and paid it to Compass. Upon the discharge of its obligations in the garnishment action, Colonial once again had the right to setoff any amount it was owed by BFS against funds in BFS’s checking account under Alabama state law. *In re Bryant*, Case No. 95-12471, Adv. No. 95-1257 (Bankr. S.D. Ala., January 7, 1997) (citing to *Rainsville Bank v. Willingham*, 485 So.2d 319 (Ala. 1986)).

3.

If Colonial Did Not Waive Its Prepetition Right of Setoff Against BFS’s Checking Account Under Alabama State Law, Is Its Right of Setoff Preserved Under 11 U.S.C. §553(a):

Once the right of setoff has been established under state law, 11 U.S.C. §553 generally preserves the right to setoff under the Bankruptcy Code. Section 553 states:

(a) Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case, except to the extent that--

- (1) the claim of such creditor against the debtor is disallowed;
- (2) such claim was transferred, by an entity other than the debtor, to such creditor--
 - (A) after the commencement of the case; or
 - (B)(i) after 90 days before the date of the filing of the petition; and
 - (ii) while the debtor was insolvent; or
- (3) the debt owed to the debtor by such creditor was incurred by such creditor--
 - (A) after 90 days before the date of the filing of the petition;
 - (B) while the debtor was insolvent; and
 - (C) for the purpose of obtaining a right of setoff against the debtor.

(b)(1) Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14), 365(h), 546(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of--

- (A) 90 days before the date of the filing of the petition; and
- (B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

(c) For the purposes of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

This Court has already found that Colonial waived its right of setoff regarding the \$6,812.43 it paid to Compass in the garnishment action. No right of setoff was preserved by

§553(a) as to that amount of money.² Colonial's waiver only applied within the garnishment action though. After Colonial was discharged in the garnishment action, it was free to exercise its right to setoff against BFS's accounts. Therefore, the Court will consider whether Colonial's right to setoff against the remaining funds in the account (funds deposited after December 11, 2002 when the balance was \$6,812.43) is preserved by §553(a).

"Section 553(a) . . . sets forth a general rule, with certain exceptions, that any right of setoff that a creditor possessed prior to the debtor's filing for bankruptcy is not affected by the Bankruptcy Code." *Citizens Bank of Maryland v. Stumpf*, 516 U.S. 16, 20 (1995). Colonial may now exercise its right of setoff against BFS's accounts if Colonial complies with the requirements of §553. "Section 553 lists three requirements: (1) the setoff must involve a mutual debt so that both the creditor and debtor owe each other money; (2) both sets of obligations must arise prior to the bankruptcy filing; and (3) the setoff cannot fall within three exceptions." *Woodrum v. Ford Motor Credit Co. (In re Dillard Ford, Inc.)*, 940 F.2d 1507, 1512 (11th Cir. 1991) (citations omitted).

A.

As to Funds Deposited Into BFS's Checking Account From December 11, 2002 Through February 18, 2003, the Petition Date?

The first of the three §553 requirements, mutuality of debts, is described as debts that are "due to and from the same person in the same capacity." *Official Committee of Unsecured Creditors v. Manufacturers and Traders Trust Co. (In re Bennett Funding Group, Inc.)*, 212 B.R. 206, 212 (2nd Cir. BAP 1997) (quoting *In re Sentinel Prods. Corp., P.I., Inc.*, 192 B.R. 41, 45

² The Court will not consider whether BFS may recover these funds as a preferential transfer at this time because BFS has filed a separate adversary proceeding complaint, Adv. No. 03-01090, against Compass to recover these funds.

(N.D.N.Y. 1996). Colonial meets §553's first requirement for the funds deposited into BFS's account from December 11, 2002 through February 18, 2003. Colonial owed BFS a debt for the amounts deposited in BFS's account during that time period and BFS owed Colonial a debt for the amount of the loan agreements BFS on which BFS had previously defaulted. Therefore, the debts were "due to and from" both parties to each other, creating a mutuality of debts.

The second of §553's three requirements, that both obligations must arise prior to the bankruptcy filing, is analogous to the first requirement of mutuality of debts for the purposes of this analysis. As stated above, Colonial and BFS each owed the other mutual debts that arose prior to BFS's bankruptcy with respect to all funds deposited into BFS's account from December 11, 2002 through February 18, 2003.

B.

As to Funds Deposited Into BFS's Checking Account After February 18, 2003?

Colonial does not meet the first of §553's three requirements for the \$2,413 deposited into BFS's checking account after BFS filed its bankruptcy petition on February 18, 2003. That money is a postpetition debt of Colonial to BFS and it cannot be setoff against a prepetition debt of BFS to Colonial because the two debts lack mutuality under §553(a). *Cox v. Billy Pounds Motors, Inc. (In re Cox)*, 214 B.R. 635, 648 n.14 (Bankr. N.D. Ala. 1997). The Court will not address whether Colonial meets the other two requirements of §553 for the money deposited into BFS's account after February 18, 2003 because Colonial fails to meet §553's first requirement.

Colonial has complied with the first two requirements of §553 as to the monies that were deposited into BFS's account from December 11, 2002 through February 18, 2003 under the test established by the Eleventh Circuit Court of Appeals in *In re Dillard Ford*. 940 F.2d at 1512.

Colonial may exercise its right of setoff against those funds unless it fails to meet the third requirement: the setoff cannot fall within the three exceptions listed in §§553(a)(1)-(3). *Id.*

4.

If Colonial's Right of Setoff Against BFS's Checking Account Is Preserved Under
11 U.S.C. §553(a), Is It Barred From Exercising Its Right of Setoff by One of the
Exceptions Listed in 11 U.S.C. §§553(a)(1)-(3)?

Sections 553(a)(1)-(3) give three exceptions to the general rule “that any right of setoff that a creditor possessed prior to the debtor’s filing for bankruptcy is not affected by the Bankruptcy Code.” *Citizens Bank of Maryland v. Stumpf*, 516 U.S. 16, 20 (1995). Sections 553(a)(1) and (2) are inapplicable in this case. The Court will only address whether Colonial is barred from exercising its right of setoff against BFS’s account under §553(a)(3). Section 553(a)(3)’s exception bars a creditor from exercising its right of setoff when the creditor incurs a debt to the debtor within 90 days of the petition date for the purpose of obtaining a right of setoff against the debtor. 11 U.S.C. §553(a)(3). The purpose of this exception is to “prevent[] the courts from rewarding creditors who persuade a debtor to engage in conduct which has the effect of impermissibly improving the creditor’s position among the other creditors.” *In re Dillard Ford* at 1513.

In this case, Colonial placed an administrative hold on BFS’s account after receiving the Compass garnishment on December 11, 2002. The hold denied BFS access to the funds in its account but it allowed monies to be deposited into the account. This resulted in the balance rising from \$6,812.43 on the date the hold was placed on the account to \$29,111.79 on February 18, 2003 when BFS filed its bankruptcy petition.

Colonial argues that the administrative hold it placed on BFS’s account is analogous to the facts in the United States Supreme Court case, *Citizens Bank of Maryland v. Stumpf*, where

the Supreme Court found that the bank's "temporary refusal . . . to pay a debt that is subject to setoff against a debt owed by the bankrupt" was permissible. 516 U.S. at 21. However, the facts in this case are not closely analogous to those in *Strumpf*. Colonial placed an administrative hold on BFS's account slightly more than two months before BFS filed its bankruptcy petition, whereas the bank in *Strumpf* only placed an administrative hold on the debtor's account well after the debtor filed his chapter 13 bankruptcy petition. *Id.* at 17-18. Moreover, the bank in *Strumpf* only placed a temporary hold on the debtor's account while it sought relief from the automatic stay from the bankruptcy court, whereas Colonial placed an indefinite hold on BFS's account that was not subject to the same protections as those afforded to the debtor in *Strumpf*. *Id.* at 19.

Notwithstanding the differences in Colonial's actions and those of the bank in *Strumpf*, BFS failed to present any evidence indicating that Colonial placed the hold on its account with the purpose of obtaining a right of setoff against BFS. The monies deposited into the account after Colonial placed a hold on it were not made by BFS. Instead, the monies were automatically credited from credit card transactions involving BFS's customers. This is not the type of "intentional build-up of funds on deposit" by the debtor with the purpose of "preferring one creditor over another" that the courts are concerned about under §553(a)(3). *In re Bennett Funding Group, Inc.*, 212 B.R. 206, 216 (2nd Cir. BAP 1997). Accordingly, the Court finds that Colonial's right of setoff against the monies deposited into BFS's account from December 11, 2002 through February 18, 2003 is not barred by any of the exceptions to setoff enumerated in §553(a)(1)-(3).

If Colonial Is Not Barred from Exercising Its Right of Setoff Against BFS's Checking Account by §§553(a)(1)-(3), May BFS Recover Any Amount of Colonial's Setoff That Is Greater Than the Amount Colonial Could Have Setoff 90 Days Before BFS Filed its Bankruptcy Petition?

“Under section 553(b), a trustee [BFS in this case] may recover the amount of a prepetition setoff, made within 90 days before bankruptcy, to the extent the amount set off exceeds what could have been set off 90 days prior to bankruptcy.” *Moreira v. Digital Employees Federal Credit Union (In re Moreira)*, 173 B.R. 965, 970 (Bankr. D. Mass. 1994). This is commonly known as the “improvement of position” test.


Notably, “the language of section 553(b)(1) refers to prepetition setoffs, not postpetition setoffs.” *Rooster, Inc. v. Raphael Roy, S.R.L. (In re Rooster)*, 127 B.R. 560, 571 (Bankr. E.D. Pa. 1991). This has led “some courts and commentators” to conclude “that the improvement of position test is irrelevant to the postpetition allowance of setoff under . . . 553” whereas other courts have employed “the improvement of position test as one factor to be considered when a court exercises its discretion in determining whether to . . . permit the creditor to setoff postpetition.” *Id.* at 571-72 (citations omitted) (cataloguing cases for and against consideration of the improvement of position test in postpetition setoffs).

In this case, Colonial could have exercised its right of setoff against BFS's account before BFS filed its bankruptcy petition on February 18, 2003. However, Colonial did not exercise its setoff right prepetition. It placed an administrative hold on BFS's account. The hold had the effect of increasing the balance of the account from \$6,812.43 on the date when the hold was placed to \$29,111.79 on the date BFS filed its bankruptcy petition -- a difference of \$22,299.36. Allowing Colonial to exercise its right of setoff against BFS's account now and receive more than it would have received if it exercised its right of setoff prepetition “smacks of a preference.” *See In re Moreira* at 970. The Court is aware of this issue. However, this Court

agrees with those courts holding that “Congress chose not to apply the improvement of position test to postpetition as well as prepetition setoff.” *Id.* at 971. Therefore, this Court holds that §553(b)’s “improvement of position test is expressly based upon an actual exercise of prepetition setoff,” *Id.*, and it cannot be applied to a postpetition setoff by Colonial.

IT IS ORDERED that Bubba’s Food Services, Inc.’s motion for turnover is partially GRANTED as to postpetition deposits and Colonial Bank’s motion for relief from the automatic stay to exercise its right of setoff under 11 U.S.C. §553 is partially GRANTED as to monies deposited from December 11, 2002 through February 18, 2003.

Dated: June 18, 2003


MARGARET A. MAHONEY
U.S. BANKRUPTCY JUDGE