

Reg. Z Requires Extra Effort to Enforce Security Interest in Consumer Deposit Account

In late December 2009, a bankruptcy court ruled that a credit union did not have a security interest in a deposit account it maintained for a consumer even though the consumer had signed an agreement purporting to grant the credit union a security interest to secure the consumer's credit card debt. The case, *In re Okigbo*, 2009 WL 5227844 (Bankr. D. Md. 2009), is potentially important for banks and credit unions that issue credit cards.

The Facts. The Maryland case arose when the consumer filed for bankruptcy protection and the credit union then put an administrative freeze on the consumer's deposit account to protect its right of setoff. Specifically, the credit union wanted to set off its obligation on the deposit account against the consumer's debt arising from the use of a credit card issued by the credit union. The consumer brought an action for violation of the stay and the credit union then moved for relief from the stay when it filed its response.

The Court's Analysis. The bankruptcy court began its analysis with the Supreme Court's decision in *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995), in which

the Court ruled unanimously that placing an administrative freeze on a deposit account contemporaneously with the filing of a motion for relief from the stay did not constitute a setoff prohibited by § 362(a)(7). The debtor responded with two points. First, the credit union had not filed a motion for relief from the stay when it froze the deposit account. Second, the credit union had no setoff rights to protect, and thus no basis for placing the freeze on the deposit account in the first place. The court found merit in both points. It is the second of the two that this article discusses.

The court concluded that the credit union could not have setoff rights because the debtor had claimed the deposit account as exempt. Following a bankruptcy court decision from two decades earlier, the court concluded that, in the absence of a security interest, "the general rule that a creditor may not exercise setoff against exempt property should prevail." *In re Cole*, 104 B.R. 736, 740 (Bankr. D. Md. 1989). In fact, while a majority of courts had treated a bankruptcy debtor's exemptions as trumping a creditor's setoff rights, the predominant view now appears to be the opposite: that a creditor's setoff rights take precedence over the debtor's exemptions. See, e.g., *In re Gould*, 401 B.R. 415 (9th Cir. BAP 2009); *In re Miller*, 2010 WL 117677 (W.D. Wis. 2010). The credit union countered that it did have a security interest because the credit card application that the debtor had signed expressly granted the credit union "a security interest in all deposit accounts you have with us now and in the future to secure your credit card account." In response to this, the court looked to Regulation Z.

Impact of Reg. Z. Regulation Z generally prohibits a credit card issuer from taking any action to offset a cardholder's indebtedness arising from a consumer credit transaction against funds of the cardholder held on deposit with the issuer. 12 CFR § 226.12(d)(1). Such a setoff is permissible if the issuer obtains a "consensual security interest in the funds," 12 CFR § 226(d)(2), however, the Official Staff Commentary severely limits what qualifies as a consensual security interest. The Official Staff Commentary is issued after a notice and comment period pursuant to the Administrative Procedures Act, and therefore is entitled to the same judicial deference that regulations are:

[R]outinely including in agreements contract language indicating that consumers are giving a security interest in any deposit accounts maintained with the issuer does not result in a security interest that falls within the exception in § 226.12(d)(2). For a security interest to qualify for the exception [t]he consumer must be aware that granting a security interest is a condition for the credit card account (or for more favorable account terms) and must specifically intend to grant a security

interest in a deposit account. Indicia of the consumer's awareness and intent could include, for example:

- Separate signature or initials on the agreement indicating that a security interest is being given[;]
- Placement of the security agreement on a separate page, or otherwise separating the security interest provisions from other contract and disclosure provisions[; or]
- Reference to a specific amount of deposited funds or to a specific deposit account number.

12 CFR Pt. 226, Supp. I.

Applying this rule to the facts before it, the court noted that the reference to a security interest was on the second page of the credit union's standard 13-page credit card application and disclosure. The court therefore concluded that the credit union did not have a security interest and, as a result, did not have setoff rights. As a further result, the court concluded that the credit union had violated the automatic stay by freezing the deposit account.

Relevance and Scope of the Decision. The Maryland bankruptcy court's decision should be a wake-up call for depositary institutions that issue credit cards and expect to be able to offset deposit account balances against credit card debt. Setoff is prohibited without a security interest, and getting a security interest entails far more than would be required under Article 9 of the Uniform Commercial Code. Article 9 does not apply to a security interest in a deposit account as original collateral in a consumer transaction. UCC § 9-109(d)(13).

That said, the court's decision and the regulations on which it is based are limited in three important respects. First, they apply only to security interests in deposit accounts; they have no relevance to security interests in any other collateral. Second, they apply only to obligations arising from the use of a credit card; they are not relevant to secured obligations arising from a loan. Third, the credit card debt must arise from a consumer credit transaction. Thus, the decision would not apply to a business debtor, even one whose obligation arises from a credit card.

The author of this story, Stephen L. Sepinuck, is a Professor at Gonzaga University School of Law. Professor Sepinuck is the former chair of the UCC Committee of the American Bar Association and currently the ABA Advisor to the Joint Review Committee for Article 9 of the UCC.