ISN'T THAT SPECIAL? NEW YORK COURT REJECTS SECURED PARTY'S RIGHT TO EXERCISE SETOFF AGAINST $509 MILLION DEPOSIT

In yet another interesting and important decision arising out of the Lehman bankruptcy, the bankruptcy court for the Southern District of New York voided a secured creditor's right to exercise setoff against a $509 million deposit account. *In re Lehman Brothers Holdings Inc.*, 2010 WL 4628139 (Bankr. S.D.N.Y. 11/16/10). With that kind of money at stake, the ruling will no doubt be appealed. In the interim, the decision provides an important lesson about common-law rights and their relationship to Article 9. Specifically, a consensual security interest can in some cases wipe out a bank's common-law right of setoff.

A security interest manufactured in the midst of meltdown. The case has its roots in the late summer of 2008, when the stock market was crashing and the credit markets were seizing up. On July 25, Lehman Brothers incurred an overnight overdraft of $650 million in a cash collateral account at Bank of America, Lehman's principal clearing bank. Transitory, intraday negative balances were routine and Lehman in fact cleared the overdraft the next business day. Nevertheless, an overnight overdraft of this magnitude, coupled with the deepening apprehension about the state of the financial markets in general and of Lehman in particular, caused BofA great concern. In response, BofA demanded a $1 billion security deposit and threatened to reduce Lehman's intraday overdraft limit to zero if security were not provided.

Lehman offered to simply place funds on deposit with BofA, but BofA refused, insisting that the funds be pledged as collateral pursuant to a security agreement. Initial drafts of the security agreement identified the secured obligation as pretty much everything: "any and all existing and future indebtedness and liabilities of every kind, nature and character ... of [Lehman] ... to [BOA]." Lehman balked at that broad dragnet and the parties eventually agreed to a much narrower definition: existing and future indebtedness "solely in respect of overdrafts."

Bank of America exercises $509 million setoff. The parties executed the security agreement on August 25 and Lehman wired $500 million to a demand deposit account at BofA. BofA transferred the funds to an offshore branch and placed a permanent hold on the deposit account, so that funds could not be withdrawn without special authorization and a manual override of the hold.

As of Lehman's petition date, there was at most a $5,000 overdraft in Lehman's other accounts with BofA. However,

Lehman owed BofA $1.9 billion in connection with some derivative transactions. Claiming a right of setoff, BofA swept the entire $509 million balance credited to the deposit account after the Chapter 11 petition had been filed. Lehman demanded that the funds be returned and BofA responded by seeking a bankruptcy court declaration that BofA had acted within its rights.

BofA's argument. Given the security agreement's narrow description of the secured obligations, it was clear that BofA could not rely on the security agreement to justify its exercise of setoff. Accordingly, BofA claimed a common-law right of setoff. In support of this, BofA pointed out that the security agreement expressly provided:

(i) that upon default, BofA could "exercise any . . . remedy provided under this Agreement or by any applicable law"; and

(ii) "The rights, powers, and remedies given to the Bank by this Agreement shall be in addition to all rights, powers, and remedies given to the Bank by virtue of any statute or rule of law."

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Bankruptcy court rejects "boilerplate." The bankruptcy court was unpersuaded by the relevance of these clauses in the security agreement. Referring to them as "boilerplate," the court ruled that their language "does not undermine the overarching purpose of the security agreement," which was to provide collateral only for overdrafts. To support this conclusion, the court recounted the negotiation between the parties and the fact that BofA had assented to Lehman's insistence that the obligations secured by the deposit account be limited to overdrafts, not all liabilities.

No setoff allowed against "special deposit." Perhaps more to the point, the court ruled that BofA had no common-law right of setoff with respect to the deposited funds. Relying on the long-standing principle that a bank may not effect setoff against "special deposits," the court ruled that the restricted nature of the pledged deposit account rendered it a special deposit not subject to setoff by the bank. In other words, while the security agreement may have preserved BofA's common-law setoff rights, in this case there were no such rights to preserve. The court noted the irony of the situation: if instead of creating a special account BofA had agreed to Lehman's offer to provide an unrestricted demand deposit account, BofA would have had the right to set off against the deposit account any mature and mutual obligation owed to it by Lehman. The setoff would have been valid.

Critique. There is some appeal to the court's decision. BofA bargained for a source of funds to cover overdrafts, and expressly agreed that the funds would not be security for other obligations. For BofA to then use the funds to discharge other, unrelated obligations seems contrary to the parties' bargain. While the agreement did expressly preserve BofA's other rights, reliance on those other rights in this case seems disingenuous. Moreover, while BofA may have always intended to have such setoff rights, such an undisclosed intent while expressly agreeing to Lehman's desire to narrow the scope of the secured obligations might present a basis for applying the "forthright negotiator" principle. *See United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. Ct. 2007).

Impact of Article 9? Nevertheless, for at least two reasons the court's analysis is somewhat suspect. First, the court never discussed or even cited UCC § 9-340(b). That section provides that "the application of this article to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party." As explained by comment 3, "[b]y holding a security interest in a deposit account, a bank does not impair any right of set-off it would otherwise enjoy." If UCC § 9-340(b) really means what the comment says, then BofA's setoff rights should not have been undermined by the existence of the security agreement.

Was it really a "special deposit"? Second, while the court did accurately describe the common law relating to so-called "special deposits," the court seems to have overlooked how that law developed and what it was intended to do. The court quoted *In re Applied Logic Corp.*, 576 F.2d 952, 958 (2d Cir. 1978), for the proposition that "a bank cannot exercise a setoff against a deposit which is known by it to be dedicated to a special use." However, the court omitted from the quotation the remainder of the Second Circuit's sentence: "e.g., for the sole purpose of meeting payrolls or paying taxes." This omitted language is critical.

The classic example of a special deposit is, as the Second Circuit indicated, a deposit account dedicated to making payroll or paying taxes. When the depositary bank knows of that purpose, the deposit account becomes analogous to a bailment or trust. The bank understands that the funds—at least in a colloquial sense—"belong to" the employees or taxing authority, and for that reason it would be inequitable

to allow the bank to use the funds to satisfy an unrelated obligation of the depositor to the bank.

In the *Lehman* case, however, there was no identified third party with an equitable claim to or expectancy in the deposit account. What made the deposit special, in the court's opinion, was Lehman's agreement to let the funds be used to satisfy overdraft obligations to BofA. This turns the doctrine of special deposits on its head. The doctrine is designed to protect third parties against the bank. If the bank is the third party, the doctrine would seem not to apply. Perhaps this point will be made on appeal.

Final point: violation of the automatic stay. After concluding that BofA had no right to exercise setoff against the "special deposit," the court went on to discuss whether the bank's actions violated the automatic stay. This portion of the decision should have been fairly simple. Whether or not it had a contractual or common-law right of setoff, BofA's post-petition actions would seem to be an improper effort to exercise control over property of the estate. While a bank that has setoff rights may place an administrative hold on a deposit account without violating the stay (*Citizens Bank of Maryland v. Strumpf,* 516 U.S. 16 (1995)), a bank may not sweep funds out of the account post-petition, as Bank of America did.

The bank defended its actions by relying on Section 362(b)(17) of the Bankruptcy Code, which exempts from the stay certain setoffs by a participant under a swap agreement. However, the court rejected this argument because the security agreement at issue was not part of a swap agreement. The court did not discuss whether the derivative transaction that gave rise to Lehman's liability was a swap agreement.

The court ordered a return of the $500 million fund plus interest, while reserving decision on sanctions to be awarded for violation of the stay.

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