N.D.A.G. Letter to Nelson (April 30, 1986)

April 30, 1986

Ms. Carol S. Nelson
Barnes County State's Attorney
P.O. Box 209
223 North Central Avenue
Valley City, ND 58072

Dear Ms. Nelson:

Thank you for your letter of January 21, 1986, in which you inquire whether a financial institution may setoff funds in a depositor's account after the sheriff has commenced the process of executing on a judgment against the depositor. I apologize for the delay in responding to your question.

Your letter does not indicate whether the financial institutions are exercising their rights of setoff before or after the sheriff has levied on the depositors' accounts. Until the sheriff actually levies upon the depositor's account, no lien on that account is created. N.D.C.C. §28-21-13. Thus, no legal basis exists for denying a financial institution its right of setoff before the sheriff levies on the account (assuming that the financial institution is legally entitled to its right of setoff; see discussion, infra, at 3-4).

A review of the case law addressing the issue of whether a financial institution may setoff funds in a depositor's account after the sheriff has levied on the account indicates that two schools of thought have developed. The majority view, based on the doctrine of automatic setoff, asserts that a financial institution may setoff funds in a depositor's account even after the financial institution has received a levy on execution from the sheriff concerning those monies. The minority view, based on the affirmative steps doctrine, prevents a financial institution from setting off a customer's funds against his indebtedness to the financial institution unless the institution has taken affirmative steps in exercising its right to setoff prior to the levy on execution.

The North Dakota Supreme Court has not been presented with the opportunity of addressing this issue and, consequently, it has not adopted either of the two approaches. Thus, it is appropriate that I discuss both doctrines before rendering my opinion.

The majority view is predicated on the principle that the judgment creditor merely steps into the shoes of the debtor and is subject to all of the defenses that could have been asserted against the debtor by the financial institution. See Pittsburgh National Bank v. United States, 657 F.2d 36 (3d Cir. 1981); United States v. Bank of Celina, 721 F.2d 163 (6th Cir. 1983); Glen Justice Mtg. Co. v. First National Bank, 592 F.2d 567 (10th Cir. 1979); General Electric Credit Corp. v. Tarr, 457 F.Supp. 935 (W.D. Pa. 1978);

F.N.B. Martinsville v. American Fletcher N.B.N.T., 480 N.E.2d 964 (Ind.Ct.App. 1985); Coyle v. Pan. Amer. Bank of Miami, 377 So.2d 213 (Fla.Dist.Ct.App. 1979); Barsco, Inc. v. H.W.W., Inc., 346 So.2d 134 (Fla. 1977); Roosevelt Fed. Savings and Loan v. First National Bank, 614 S.W.2d 289 (Mo.Ct.App. 1981); Tumarkin v. First National State Bank of New Jersey, 361 A.2d 550 (N.J. 1976); Industrial Commission v. Five Corners, 419 N.Y.S.2d 931 (N.Y.Ct.App. 1979); John M. C. Marble Co. v. Mer- chants National Bank, 115 P. 59 (Ca. 1911); Holloway v. First National Bank, 265 P. 699 (Id. 1928); Farmers State Bank v. Van Houten, 219 N.W. 106 (S.D. 1928); Aarons v. Public Service Building, 178 A. 141 (Pa. 1935); Marrison v. Hougue, 95 N.E.2d 15 (Ohio 1950).

In Tumarkin v. First National State Bank of New Jersey, the defendant bank setoff a corporation's funds on deposit against its indebtedness after the corporation had executed an assignment for the benefit of its creditors. Pursuant to statute, the plaintiff assignee was clothed with the right to recover the debtor's assets and was granted the same priority status as a "holder of a judgment in levy against assignor and his property at the date of the assignment." 361 A.2d at 553.

The court, accepting the bank's right of setoff in this situation, summarized the automatic setoff doctrine as follows:

> [T]he attachment did not alter the contractual relations between the garnishee and the principal debtor. The attached interest is the actual debt of the garnishee to the principal debtor. It is axiomatic that the plaintiff in attachment can have no greater rights against the person summoned as a garnishee than the defendant in attachment. There can be no question but that the garnishable interest of the defendant is subject to the garnishee's right of offset at the time of the execution of the writ, at the very least. This is a rule of general acceptance.

Id. at 554 (quoting Russell v. Fred G. Pohl Co., 80 A.2d 191, 195 (N.J. 1951)).

In General Electric Credit Corp. v. Tarr, the bank exercised its right of setoff after it had been served with a writ of execution by a judgment creditor. The district court, applying Pennsylvania law, held that the bank's right to setoff is not "overridden by an attachment execution. . .and that the right need not be asserted until someone shall commence an attachment execution." 457 F.Supp. at 937.

> Even in the majority of jurisdictions that adopt the automatic setoff rule, the financial institution must still establish that it has a legal right to setoff at the time it exercises such right. For a bank to establish its right to setoff, case law has established that three conditions must be met:
>
> 1. The fund to be setoff must be the property of the debtor;
>
> 2. The fund must be deposited without restrictions; and

3. The existing indebtedness must be due and owing .

Spratt v. Security Bank of Buffalo, Wyoming, 654 P.2d 130, 136 (Wyo. 1982).

In addition, N.D.C.C. §6-03-67 prohibits setoff "without legal process or the consent of the depositor." In the factual situation presented in your letter, it is apparent that the setoff is being exercised pursuant to the depositor's consent which is customarily obtained at the time the original loan contract is executed.

The consent requirement of N.D.C.C. §6-03-67 is further discussed in N.D.C.C. §41-04-28.1, which states as follows:

> 41-04-28.1. INTERFUND SETOFFS -- REQUIRED NOTICE TO DEPOSITOR -- SEPARATE DOCUMENT REQUIRED. A financial institution may provide by contract for the privilege of setting off deposits in the account of a depositor. The contract meets the consent requirement of section 6-03-67, if, at the time the contract is entered into, a written disclosure is made of the right of setoff and the effect of that right on the depositor's other accounts and the depositor has signed a separate document agreeing to those terms. The written disclosure required by this section must be conspicuous as defined under subsection 10 of section 41-01-11. The financial institution shall give immediate notice to the depositor when a setoff action is taken. "Financial institution" means any organization authorized to do business under state or federal laws relating to financial institutions, including the Bank of North Dakota, a bank, a savings bank, a trust company, a savings and loan association, or a credit union.

The determination of whether a North Dakota bank has the right of setoff under the automatic setoff doctrine requires an analysis of the factual circumstances in light of the above three requirements developed by the courts and the pertinent North Dakota statutes (N.D.C.C. §§6-03-67, 41-04-28.1).

The minority view on the right to setoff after the levy on execution has been served on the financial institution requires that affirmative steps be taken by the financial institution prior to the service of execution. Baker v. National City Bank of Cleveland, 511 F.2d 1016 (6th Cir. 1975); United States v. Citizens and Southern National Bank, 538 F.2d 1101 (5th Cir. 1976); United States v. Sterling National Bank and Trust Company, 494 F.2d 919 (2d Cir. 1974); Bank of America National Trust and Savings Association v. United States, 345 F.2d 624 (9th Cir. 1965); Bank of Nevada v. United States, 251 F.2d 820 (9th Cir. 1958); United States v. First National Bank of Arizona, 348 F.Supp. 388 (D. Ariz. 1970), aff'd, 458 F.2d 513 (9th Cir. 1972).

In Baker v. National City Bank of Cleveland, the defendant bank exercised its right of setoff in the midst of a bankruptcy reorganization proceeding. The bank had indicated an intent to setoff but had not completed the setoff process prior to the bankruptcy

court's order restraining such setoffs by any creditors of the debtor. Accepting the bankruptcy trustee's argument, the court reasoned that the right of setoff is subject to intervening legal processes unless the financial institution has taken three affirmative steps:

1. The decision to exercise the right,

2. Some action which accomplishes the setoff, and

3. Some record evidences that the right of setoff has been exercised.

511 F.2d at 1018.

In U.S. v. First National Bank of Arizona, the defendant bank exercised its right of setoff after the United States had served a tax levy on the bank. The court rejected the bank's right of setoff under these facts and stated as follows:

> Until a bank has notified its depositor and then exercised its right of setoff, the depositor is free to withdraw from his account and it is inconceivable that Congress * * * intended to prohibit the government from levying on that which is plainly accessible to the delinquent taxpayer-depositor.

348 F.Supp. at 389.

The North Dakota Supreme Court has never had the opportunity to adopt one of the two competing theories. However, N.D.C.C. §41-04-28.1 suggests that the Legislature intended that affirmative steps be taken prior to setoff. ("The financial institution shall give immediate notice to the depositor when a setoff action is taken.") The automatic setoff doctrine, thus, would not be consistent with the notice provision of N.D.C.C. §41-04-28.1.

Additionally, there are sound policy reasons for requiring a financial institution to take affirmative steps in exercising its right of setoff. The policy of the Uniform Commercial Code (N.D.C.C. Ch. 41-04), sound banking practices, and generally accepted accounting principles require that internal banking transactions involving adverse interests be evidenced by bookkeeping entries or similarly binding overt acts. This policy not only provides criteria for resolving competing claims, but also assures that those who deal with financial institutions will not have their rights "defeated by unsupported internal declarations of a self-serving nature." Baker, 511 F.2d at 1018. The confidence of the banking system and orderly legal process strongly support an affirmative steps approach to the right of setoff.

The affirmative steps doctrine is consistent with N.D.C.C. §41-04-28.2 and is supported by sound policy considerations. It is my opinion, therefore, that a bank's right of setoff is preempted by a sheriff's levy of execution on a depositor's account.

Sincerely,

Nicholas J. Spaeth

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