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Michigan Court of Appeals rules claiming right of setoff versus actually exercising it is adequate

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Marc P. Jerabek, CIPP/US
(248) 901-4016
mjerabek@plunkettcooney.com

The Michigan Court of Appeals recently ruled that a garnishee defendant bank need not *exercise* its right of setoff but may merely assert it to maintain priority in the money on deposit over the rights of the judgment creditor.

While the court's holding in *Ladd v Motor City Plastics Company*, ___Mich. App. ___; 2013 WL 5857395 (2013) is clear, caution is necessary in order to preserve a claim of setoff and to avoid a potential unintentional waiver of that claim.

In this case, Ladd obtained a judgment against Motor City Plastics Company (Motor City) in the amount of $113,200 and then served a writ of non-periodic garnishment on United Bank & Trust (the Bank), where Ladd believed Motor City had funds on deposit. The Bank submitted a garnishee disclosure stating that it was "not indebted to Motor City for any amount" and did "not possess or control Motor City's property, money, etc."

Instead, the Bank claimed a right of setoff against any money Motor City had on deposit with the Bank and attached a short supplement to its garnishee disclosure, explaining that Motor City was in default under certain loan documents payable to the Bank and that Motor City was "indebted to [the Bank] under the loan documents in an amount in excess of the value of Motor City's accounts with [the Bank]."

Deposition testimony and affidavits of the Bank declared that Motor City was in default on three different loans totaling more than $1.5 million at the time the garnishment was served.

Ladd conducted a debtor's exam of Motor City which testified that the Bank never exercised its claimed right of setoff against Motor City's accounts and that Motor City continued to use its accounts and withdraw funds, even after the garnishment was served on the Bank. Ladd then moved for assessment of the amount due on the judgment and contempt sanctions against the Bank, arguing that the Bank had knowingly provided false answers on its garnishee disclosure.

A trial was held, and the Bank officials testified that Motor City continued to have unrestricted access to its accounts after the garnishment was served and that the Bank was concerned that exercising its right of setoff would essentially put Motor City out of business, thus further impairing the Bank's loan collateral.

The trial court found that the pre-printed, garnishee disclosure language in the Michigan State Court Administrative Office's (SCAO) form made the Bank's response confusing, that the Bank should have crossed out the misleading form language, but that the Bank did not intend to mislead Ladd. The trial court then held that the Bank was not required to withhold the funds from Motor City in order to claim its right of setoff.

On appeal, the Michigan Court of Appeals affirmed. The appellate court agreed that the SCAO garnishee disclosure form is confusing, particularly because no check-box or blank is provided where a bank could claim its right of setoff, and that the Bank should have stricken the inapplicable language in the form or prepared its own garnishee disclosure. However, the appellate court found that the Bank's garnishee disclosure, plus its explanatory attachment provided adequate disclosure and, therefore, was not misleading.

The appellate court then held that it was sufficient for the Bank to merely *claim* its right of setoff on the garnishee disclosure and that it was not required to exercise that right or seize the funds. It found that a claim of setoff may be made after service of a garnishment and that, under MCR 3.101(G)(1), a garnishee must disclose "any setoff that the garnishee *would* have against the judgment debtor …" (emphasis in original).

While the appellate court indicated that Ladd had the right to challenge the *claim* of setoff through discovery and ultimately trial, since the Bank had a superior right to any funds in Motor City's account, that Ladd would never have been entitled to any of these funds. The court further held that the Bank did not waive its right to setoff or its perfected security interest in the funds by allowing Motor City to continue to withdraw money from its accounts. It ruled that "there can be no waiver of a right where the right to be asserted is absolute over the plaintiff, who has no more rights to the account funds than the defendant Motor City," and that no facts suggested that the Bank intended to otherwise waive or release its security interest.

Judge Kathleen Jansen dissented from the majority, stating that allowing a garnishee to only *claim* its right of setoff but not *exercise* it facilitates collusion between the garnishee and the judgment debtor to defeat the judgment creditor's claim. She further stated that the Bank's actions, by allowing Motor City continued access to the funds, were inconsistent with any purported intent to setoff. Jansen relied upon § 4-303(1) of the Uniform Commercial Code and decisions from other states in concluding that a bank's right of setoff is not effective until it is exercised or a bank takes some unequivocal, objective act toward setoff. Finally, Jansen found that any claim to setoff that the Bank had was subsequently waived

when the Bank permitted Motor City to use and withdraw funds from the deposit accounts – acts she determined were inconsistent with any claim to setoff.

While the *Ladd* decision is clear, caution is recommended in these situations in order to ensure that a creditor's setoff right is preserved and that an unintentional waiver does not result. It is advisable that the language of garnishee disclosures is carefully scrutinized and that any necessary attachments are used to avoid any confusion and to reduce the risk that a garnishor may claim it was misled.

In addition, while the *Ladd* court found no facts present, it recognized the potential that acts taken by a bank after its claim of setoff could be seen as collusive with the judgment debtor and could waive that setoff claim. The majority offered nothing further regarding what may constitute such collusion or result in a waiver of that claim.

While *Ladd* provides creditor's cover when setoff is merely claimed, one sure and advisable way to prevent challenge is to sufficiently disclose and promptly exercise any right of setoff.