UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
SOUTH BEND DIVISION

IN THE MATTER OF	)	
	)	
RODNEY W. ZECK and	)	CASE NO. 03-34989 HCD
STACI R. ZECK,	)	CHAPTER 7
	)	
DEBTORS.	)	
	)	
J. RICHARD RANSEL, Trustee,	)	
	)	
PLAINTIFF,	)	
vs.	)	PROC. NO. 06-3029
	)	
SALIN BANK AND TRUST COMPANY,	)	
	)	
DEFENDANT.	)	

J. Richard Ransel, Esq., Trustee, Thorne Grodnik L.L.P., 228 West High Street, Elkhart, Indiana 46516;

Jordan P. Williams, Esq., attorney for Trustee, Thorne Grodnik L.L.P., 228 West High Street, Elkhart, Indiana 46516; and

James R. Schrier, Esq., attorney for defendant, 415 Columbia Street, Suite 3000, P.O. Box 280, Lafayette, Indiana 47902-0280.

MEMORANDUM OF DECISION

At South Bend, Indiana, on December 14, 2006.

Before the court in this adversary proceeding is the Complaint to Avoid Setoff filed by J. Richard Ransel, Chapter 7 Trustee ("Trustee") for the debtors Rodney W. Zeck and Staci R. Zeck ("debtors"). The Complaint seeks to avoid the setoff taken by Salin Bank and Trust Company ("Bank") pursuant to 11 U.S.C. § 553(b). The Bank filed an Answer and Affirmative Defenses. After a pre-trial conference, the parties filed a Stipulation of Facts and briefs on the issue of setoff under § 553(b). The court then took the matter under advisement. For the reasons that follow, the court denies the Trustee's Complaint.

Jurisdiction

Pursuant to 28 U.S.C. § 157(a) and Northern District of Indiana Local Rule 200.1, the United States District Court for the Northern District of Indiana has referred this case to this court for hearing and determination. After reviewing the record, the court determines that the matter before it is a core proceeding within the meaning of § 157(b)(2)(E) over which the court has jurisdiction pursuant to 28 U.S.C. §§ 157(b)(1) and 1334. This entry shall serve as findings of fact and conclusions of law as required by Federal Rule of Civil Procedure 52, made applicable in this proceeding by Federal Rules of Bankruptcy Procedure 7052 and 9014. Any conclusion of law more properly classified as a factual finding shall be deemed a fact, and any finding of fact more properly classified as a legal conclusion shall be deemed a conclusion of law.

Background

The parties have stipulated to the following relevant facts in this adversary proceeding. On July 11, 2002, before they sought bankruptcy protection, the debtors borrowed $50,000 from the Bank and executed a Promissory Note ("note") and an Agricultural Security Agreement ("security agreement"). *See* R. 18, Ex. A, B. The note was secured by the collateral described in the security agreement. The Bank filed a financing statement with the Secretary of State on August 8, 2002. *See id.*, Ex. C. At the Bank, the debtors maintained two depository accounts and a loan account, through which the loan payments were made to the Bank.

On July 1, 2003, the Debtors failed to make the loan payment. On July 16, 2003, the Bank notified the Debtors by letter that they were in default and demanded payment of the entire amount of the loan, $52,486.93. However, the debtors failed to make that payment as directed. On August 21, 2003, therefore, the Bank debited $26,832.25 from one checking account and $21.44 from the other checking account, for a total setoff of $26,853.69, as partial satisfaction of the outstanding obligation owed by the debtors on the promissory note. After the principal balance on the loan account was reduced by $26,853.69, the remaining balance was $23,141.31. Eight days later, on August 29, 2003, the debtors filed for relief under the Bankruptcy Code. They

originally filed a chapter 12 bankruptcy case, but later converted it to a chapter 7 case. J. Richard Ransel is the Chapter 7 Trustee in bankruptcy for the debtors.

Discussion

On August 21, 2003, the Bank exercised its right of setoff, which "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 v. Strumpf* , 516 U.S. 16, 18, 116 S. Ct. 286, 289, 133 L.Ed.2d 258 (1995) (quoting *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 528, 33 S. Ct. 806, 808, 57 L.Ed. 1313 (1913)). Although the Bankrupcy Code did not create a federal right of setoff, it recognized and preserved "whatever right of setoff otherwise exists." *Id.* In this case, Indiana law governs the Bank's right of setoff. It is well settled in Indiana that, when the debtors, as depositors, became indebted to the Bank, a mutual debtor-creditor relationship arose, and that relationship justified the Bank's right of setoff.[1] The Trustee does not challenge the Bank's right under Indiana law to set off the defaulted loan against the checking account balances prior to bankruptcy. Instead, he seeks to recover the prepetition setoff under federal bankruptcy law.

Section 553(b) of the Bankruptcy Code "is a direct avoidance provision" which allows a trustee to "recover from any creditor the amount of a prepetition setoff to the extent that the setoff permitted the creditor to recover more than the creditor would have recovered if the setoff had occurred at certain benchmark points in time." 5 *Collier on Bankruptcy* ¶ 553.09[2] at 553-91 (Alan N. Resnick & Henry J. Sommer, eds.-in-chief, 15th ed. rev'd 2006). The statute provides:

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[1] Indiana law grants banks a right of setoff. *See INB Banking Co. v. Opportunity Options, Inc*., 598 N.E.2d 580, 584 (Ind. App. 1992) (recognizing the common-law principle of a bank's right of set-off, codified as Ind. Code § 26-1-4-401); *see also First Bank of Whiting v. Samocki Bros. Trucking Co.*, 509 N.E.2d 187, 198-99 (Ind. App. 1987) (finding that a bank's right of setoff is well entrenched in Indiana common law and case law). Section 26-1-4-401(a) of the Indiana Code, following its counterpart in the Uniform Commercial Code, states: "A bank may charge against the account of a customer an item that is properly payable from that account even though the charge creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and the bank." Ind. Code § 26-1-4-401(a).

> (b)(1) ... 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.

11 U.S.C. § 553(b). The statute also creates a presumption of the debtor's insolvency in that 90-day period before he files bankruptcy. *See* § 553(c). "The purpose of section 553(b) is to discourage creditors from taking setoffs against debts owed to insolvent debtors under circumstances where a creditor might be sorely tempted to take a setoff because of an improved setoff opportunity." 5 *Collier on Bankruptcy* ¶ 553.09[2] at 553-91; *see also Lopes v. U.S. Dep't of Housing & Urban Dev. (In re Lopes)*, 211 B.R. 443, 449 (D.R.I. 1997) ("Congress' purpose in enacting section 553(b)(1) was to prevent an 'improvement in position' by one creditor at another's expense – not to prohibit a setoff of a mutual debt that arises during the prepetition period.").

In light of that purpose, § 553(b) "permits a trustee to recover a prepetition setoff by a creditor to the extent the creditor 'improved its position' relative to other creditors by setting off within ninety days of the filing of the petition." *Parker v. Community First Bank (In re Bakersfield Westar Ambulance, Inc.)*, 123 F.3d 1243, 1245 (9th Cir. 1997); *see also Turner v. Small Business Admin. (In re Turner)*, 96 F.3d 465, 467-68 (10th Cir. 1996); *Braniff Airways, Inc. v. Exxon Co., U.S.A.*, 814 F.2d 1030, 1040 (5th Cir. 1987); *Smith v. Mark Twain Nat'l Bank*, 805 F.2d 278, 289-90 (8th Cir. 1986); *Campos v. Wells Fargo Bank, N.A.*, 345 B.R. 678, 684-85 (E.D. Calif. 2005); *Quinn v. Montrose State Bank (In re Intermountain Porta Storage, Inc.)*, 74 B.R. 1011, 1017 (D. Col. 1987); *Warsco v. Household Bank F.S.B.*, 272 B.R. 246, 252 (Bankr. N.D. Ind. 2002), *aff'd*, 334 F.3d. 638 (2003); *cert. denied*, 540 U.S. 1073 (2003); *cf. P.A. Bergner & Co. v. Bank One (In re P.A. Bergner & Co.)*, 140 F.3d 1111, 1116-17 (7th Cir.), *cert. denied*, 525 U.S. 964 (1998) (in dictum).

In this case, the Trustee claims that the Bank improved its position by means of the August 21, 2003 setoff. The Trustee provided detailed figures and applied the statute's test for determining what amounts he would be able to recover after the Bank's setoff within 90 days of the petition. *See* R. 19 at2-3. He stated that, on May 31, 2003, the ninetieth day before the debtors' bankruptcy filing, the principal balance on the debtors' loan account was $49,995.00; the balance for checking account #1 was overdrawn; and the balance for checking account #2 was $37.44. On the ninetieth day prior to the debtors' bankruptcy filing, therefore, the insufficiency in the mutual obligations owing between the debtors and the Bank was $49,957.56. On August 20, 2003, the Debtors' principal balance on the loan account remained at $49,995.00. On August 21, 2003, the balance of checking account #1 was $27,091.61 and the balance of checking account #2 was $21.44 . On that day, the Bank debited $26,832.25 from checking account #1 and $21.44 from checking account #2, for a total setoff of $26,853.69. On the same date, the Bank reduced the principal balance on the loan account by $26,853.69. After the setoff, therefore, the remaining principal balance on the loan account was $23,141.31. The Trustee contends that he is entitled to recover from the Bank $26,816.25, which is the difference between the first insufficiency, $49,957.56, and the second insufficiency, $23,141.31, because the Bank improved its position by that amount.

The Bank does not challenge the Trustee's calculations. It agreed with the Trustee, in the Stipulation of Facts and in its brief, that on August 21, 2003, it debited the amounts of $26,832.25 and $21.44 from the debtors' two checking accounts and reduced the principal balance owed under the promissory note by that amount, $26,853.69. R. 20 at 2. However, it presents two affirmative defenses.[2] The one that the court addresses is the Bank's assertion that its claim against the debtors, secured under the promissory note by the collateral described in the security agreement, is not subject to the recovery provisions of 11 U.S.C. § 553(b). According to the Bank, § 553 applies only to setoffs of mutual unsecured obligations. *See id.* at 2-3. The Trustee replied,

[2] The Bank's defense that it has a perfected security interest in the debtors' deposit accounts is challenged by the Trustee, who argues that the Bank does not hold a security interest in the deposit accounts under either Indiana's secured transactions statute or the agricultural security agreement. Because, as discussed *infra*, it is undisputed that the Bank's setoff was valid under Indiana law, and because the issue is whether the Trustee can recover the setoff funds under § 553(b), the court need not address this affirmative defense.

however, that § 553 does not distinguish between secured and unsecured claims. "The setoff provisions and 'improvement of position' test co-exist with the status of a claim as secured, unsecured, or a combination of the two." R. 21 at 2.

The court first finds that the Bank's setoff was valid. It is undisputed that the debtors did not make a scheduled loan payment, that the Bank sent them written notice of the default, and that they failed to cure the deficiency. A bank's right of setoff, when the debtors are indebted to the bank, is justified under Indiana law. *See* Ind. Code § 26-1-4-401; *INB Banking Co. v. Opportunity Options*, 598 N.E.2d 580, 584 (Ind. App. 1992). Nevertheless, because the funds were set off within 90 days of the debtors' bankruptcy filing, the court considers whether those funds are eligible to be recovered by the Trustee under § 553(b). The Trustee asserts that, once the Bank within that preferential period debited the debtors' two checking accounts and used those setoff amounts to reduce the principal balance owed under the promissory note, the Bank improved its position and thus received an advantage over other creditors, one that the Trustee could avoid under § 553(b). *See, e.g., French v. Bank One (In re Rehab Project, Inc.)*, 238 B.R. 363, 370 (Bankr. N.D. Ohio 1999) (stating that § 553(b) "requires a creditor to return to the bankruptcy estate any prepetition setoff to the extent to which the creditor improved its position by the setoff during the 90-day period immediately preceding the debtor's bankruptcy petition"). However, the Bank insists that the improvement-of-position test of § 553(b) does not apply to a bank's pre-petition setoff when the bank's claim is secured.

Just as state law governs the Bank's right of setoff, it also governs whether the Bank holds a security interest in the debtors' property. *See Butner v. United States*, 440 U.S. 48, 55, 99 S. Ct. 914, 918, 59 L.Ed.2d 136 (1979); *In re Bakersfield Westar Ambulance, Inc.*, 123 F.3d at 1246. The parties stipulated that the promissory note executed by the debtors was secured by the security agreement, which granted to the Bank a security interest in all general intangibles, farm equipment, choses in action, and other intangible personal property. *See* R. 18, Ex. A, B. By filing its financing statement with the Indiana Secretary of State, the Bank perfected its security interest in the collateral listed in the security agreement. *See Commercial Credit Counseling Servs., Inc. v. W.W.*

Grainger, Inc., 840 N.E.2d 843, 848 (Ind. App. 2006) ("Perfection of a security interest, which gives a creditor priority in the collateral to the exclusion of unperfected and subsequently perfected creditors, is generally accomplished by possession of the collateral, or by filing a financing statement with the Indiana Secretary of State.") (citing statutory provisions); *see also Fifth Third Bank v. Bentonville Farm Supply, Inc.*, 629 N.E.2d 1246, 1252 (Ind. App. 1994); *Citizens Nat'l Bank v. Wedel*, 489 N.E.2d 1203, 1206 (Ind. App. 1986). "A properly filed financing statement 'serves as notice to the rest of the world the secured party has taken a security interest in the collateral.'" *Allen v. First Nat'l Bank of Monterey*, 845 N.E.2d 1082, 1085 n.6 (Ind. App. 2006) (quoting *Brown v. Indiana Nat'l Bank*, 476 N.E.2d 888, 891 (Ind. App.1985)). The court finds that the Bank holds a properly perfected security interest under the security agreement securing the promissory note between the Bank and the debtors. It further finds that the description of the collateral in the security agreement was sufficient to put an ordinarily prudent person on notice of the Bank's security interest in the farm equipment and general intangibles of the debtors. *See Fifth Third Bank v. Comark, Inc.*, 794 N.E.2d 433, 441 (Ind. App. 2003) (citations omitted); *Cargill, Inc. v. Bunker Hill Elevator Co., Inc.*, 505 N.E.2d 75, 81 (Ind. App. 1987).

The question remains whether § 553(b) applies only to setoffs of mutual unsecured obligations and not to the Bank's secured claim against the debtors. According to the respected bankruptcy treatise *Collier on Bankruptcy*, "if the creditor [Bank] is otherwise secured, it may have a complete defense to the trustee's action under section 553(b)." 5 *Collier on Bankruptcy*, ¶ 553.09[2][e] at 553-97. Courts have concluded that "secured claims do not come within the scope of [§ 553(b)]." *Quinn*, 74 B.R. at 1017. In *Quinn*, the Georgia district court relied on the reasoning of *In re The Union Cartage Company:*

> Under section 506(a) a secured claim is always fully secured. It follows that a creditor cannot improve his position with respect to a secured claim. A secured claim therefore cannot be subject to an insufficiency under section 553(b). Stated differently, only an unsecured claim can be subject to an insufficiency.

The Union Cartage Co. v. Dollar Sav. & Trust Co. (In re The Union Cartage Co.), 38 B.R. 134, 138 (Bankr. N.D. Ohio 1984)*; see also In re Summit Financial Servs, Inc.*, 240 B.R. 105, 121-22 (Bankr. N.D. Ga. 1999)

(concluding that the trustee could not recover setoffs under § 553(b) because of the bank's status as a secured creditor).

Some courts, such as *Moody & Newton, Inc. v. Sun Bank/Suncoast, N.A. (In re Moody & Newton, Inc.)*, 71 B.R. 55 (Bankr. M.D. Fla. 1987), have begun with the axiom "that a fully secured claim cannot form the basis of an insufficiency under § 553(b)," *id.* at 57, and have set an evidentiary hearing to determine the value of the collateral before deciding whether the Bank was fully secured. *See also Davis v. Wells Fargo & Co. (In re Haynes)*, 309 B.R. 577, 580 n.7 (Bankr. D. Ariz. 2004) (stating that "setoffs are never avoidable if the bank was fully or oversecured on the 90th day prepetition, because then there would have been no deficiency that could be reduced," finding the Bank unsecured and the setoffs avoidable); *Citizens Bank v. Hamilton (In re Process Valve Automation, Inc.)*, 217 B.R. 96, 97 (Bankr. D.R.I. 1998) (finding that, if a bank "is a fully secured creditor, i.e., not undersecured, there can be no insufficiency under Section 553(b) and therefore no recoverable setoff," setting a valuation hearing). However, the Trustee in this case has not requested such a valuation.

The Trustee, having brought the complaint herein and with the statutory authority to avoid the setoff under § 553(b), bears the burden of establishing that the setoff was avoidable. *See Morin v. OYO Instruments L.P. (In re Labelon Corp.)*, __ B.R. __, 2006 W.L. 2516386 at *3 (Bankr. W.D.N.Y. 2006); *cf. In re Rehab Project, Inc.*, 238 B.R. at 374 (placing burden on Trustee under § 553 and § 105). In this case, the Trustee has stipulated that the security agreement granted the Bank a security interest in all the debtors' general intangibles and farm equipment; he has conceded that the Bank holds a secured claim. He has not raised the question whether the Bank's claim is fully secured or undersecured. He has not attempted to demonstrate that the Bank holds an unsecured or undersecured claim. In the view of this court, therefore, the Trustee has not met his burden of proving that the Bank's setoff could be avoided.

This court agrees with the reasoning of *In re Summit Financial Services, Inc.*, and the earlier cases cited above: A creditor holding a secured claim cannot improve its position, and thus a secured claim cannot be subject to an insufficiency. As a result, a setoff of funds by a creditor holding a secured claim cannot be

recovered or recaptured for the debtors' estate by a trustee pursuant to § 553(b). The court determines that the Bank, holding a secured claim against the debtors and having executed a valid setoff, has a complete defense to the Trustee's action under § 553(b). In other words, the Bank's secured claim does not come within the scope of § 553(b) and is not eligible for avoidance by the Trustee. Accordingly, it denies the Trustee's Complaint to Avoid Setoff.

Conclusion

For the reasons stated above, the Trustee's Complaint to Avoid Setoff is denied.

SO ORDERED.

/S/ HARRY C. DEES, JR.
HARRY C. DEES, JR., CHIEF JUDGE
UNITED STATES BANKRUPTCY COURT