HOW THREE SIMPLE LESSONS CAN SAVE A BANK A HALF-MILLION BUCKS; OR *IN RE SOUTHWESTERN GLASS CO., INC.*: THE EFFECT OF A GARNISHMENT ON AN AUTOMATIC DRAW LINE OF CREDIT

In June 2003, the Eighth Circuit Court of Appeals handed down its ruling in the case of *In re Southwestern Glass Co., Inc.* This case began with a $517,000 judgment against one of Bank of Arkansas' customers and ended in a $583,628.52 ruling against the bank. This case provides a powerful warning to banks and important lessons on how to better respond to garnishments and structure automatic draw lines of credit.

The story began a long time before the ruling against Bank of Arkansas. The bank and Southwestern Glass entered into a Loan Agreement and executed a Variable Rate Commercial Revolving or Draw Note. Under the terms of the agreement, Southwestern received a $1,000,000 line of credit to use for working capital. The Bank and Southwestern established a loan manager account, which is commonly called an automatic draw account or sweep account, for Southwestern to draw against the loan. This account was maintained at a zero balance. When the bank received a check written on the account by Southwestern, the bank transferred loan proceeds to the loan manager account then immediately debited the proceeds from the loan manager account to honor the check (assuming, of course, Southwestern had sufficient remaining credit under the loan).

About a year after the agreement, Waelder Oil & Gas, Inc. obtained a $517,000 judgment against Southwestern, and Waelder obtained a writ of garnishment against all of Southwestern's accounts at Bank of Arkansas. When the bank received the garnishment, the bank refused to honor the request to garnish the loan manager account (the bank did garnish a regular $5,000 checking account). The bank argued the

garnishment could not attach because the account had a zero balance since the Bank only put money in the account when it received a check. This meant, in reality, the account only had money in it for a split second before the bank paid out the funds to honor a check, leaving a zero balance at all other times. Waelder sent several interrogatories to the bank and every time the bank refused to honor the garnishment on the grounds the account had no money in it.

As often happens in circumstances like these, Southwestern declared bankruptcy before paying off Waelder. So Waelder looked for an alternative source of recovery. In this case, Waelder decided to sue the bank. Waelder claimed the bank was dishonest in its response to the garnishment. Under Arkansas law if someone gives a dishonest response to a garnishment, then that person must pay the entire judgment plus interest and the other side's attorneys' fees. Therefore, the bank became a tempting target for Waelder.

Unfortunately for the bank, the court determined that the bank's response was dishonest. The court agreed Waelder could not legally garnish the line of credit directly. However, the law does allow a creditor to garnish the proceeds of a line of credit before the money is paid to other creditors. In other words, Waelder could not garnish the money before the bank distributed it nor could Waelder garnish the money after the bank used the money to honor a check. However, the court believed the money was subject to garnishment during the split second between the time the money left the line of credit and the time the bank used the money to honor a check. As a result, the court found the bank improperly answered that Waelder could not garnish the loan manager account. Therefore, the court considered the bank's response false and forced the bank to pay the

entire amount of Waelder's judgment against Southwestern along with ten percent interest and attorneys' fees.

Lesson One: Respond Appropriately to Garnishments

If Bank of Arkansas had simply allowed Waelder to garnish the account, the bank would not have lost well-over half a million dollars (not to mention the bank's own attorneys' fees). This leads to Lesson One: when faced with a garnishment, it is always best to respond quickly and thoroughly. Waelder served the bank with interrogatories as part of the garnishment process. The bank should have explained the nature of the automatic draw account. The bank's response that the account had a zero balance was evasive; even if technically true at the time the bank made the response. The court viewed this answer as enough of a half-truth to punish the bank, which proves it is always better to tell the whole-truth.

On a related point, *In re Southwestern Glass Co.* should encourage every bank, even a bank which does not offer automatic draw accounts, to reevaluate how the bank responds to garnishments. Garnishments are potential sources of great liability, as the large judgment against Bank of Arkansas demonstrates. A bank must fight the temptation to treat garnishments as routine. A bank should treat every garnishment very seriously. All banks should have at least one or two managers who the bank thoroughly trains on the proper way to respond to a garnishment. One of those managers should supervise the administration of every garnishment from the moment the garnishment arrives until the moment the judgment is satisfied. The supervising manager should have the responsibility to communicate the garnishment to all of the appropriate people

including the bank's lawyers and the officers in the bank who make the decisions on whether to lend money to a customer. If another employee does the actual work to respond to the garnishment, then the specially-trained manager should at least review the work and sign off on it. If a particular garnishment seems unusual to the manager or involves a special type of account, then the bank should not hesitate to seek legal advice. The cost of legal fees for advice is nowhere near the cost of the litigation or penalties which can arise from mishandling a garnishment.

Lesson Two: Automatic Draw Accounts Can Be Garnished

The second lesson of *In re Southwestern Glass Co.* is automatic draw accounts are garnishable. Commercial automatic draw accounts are not extremely common in Arkansas, but many banks offer other types of automatic draw accounts, particularly in the context of home equity lines of credit. This ruling therefore has consequences for nearly all banks.

Banks can take two steps to respond to the case. First, if a bank receives a writ of garnishment for a customer who has an automatic draw account, then the bank should allow the writ of garnishment to attach. Second, a bank should include language in its loan agreements to give the bank flexibility in handling a garnishment. Loan agreements should give a bank the option to either terminate the line of credit and close the automatic draw account or suspend the line of credit and the account until the judgment against the borrower is satisfied. If the bank elects to suspend the line of credit and the draw account, then the loan agreement should also grant the bank the option to terminate the line of credit and close the account at any time before the judgment is satisfied. Not only

that, the loan agreement should be structured to allow the bank refuse to reopen the account even after the judgment is satisfied. It is important for a bank to have flexibility to decide how to handle a garnishment. A bank should consider the financial strength of the borrower relative to the judgment to decide whether the garnishment might be the harbinger of financial distress for the borrower. By allowing the bank to suspend or cancel the account, the bank can limit its potential liability from a garnishment.

Lesson Three: Structure Automatic Draw Accounts Properly

The third lesson from the case is a bank should be careful how it structures its automatic draw accounts. The court stated its decision would have been different if the automatic draw account had been restricted to a specific and limited use. "Special draw accounts" are accounts the customer may only use for specific and limited purposes. Special draw accounts are not legally subject to garnishments. A special draw account must contain specific limiting language (*e.g*, "the proceeds of this loan can only be used to pay expenses related to raising crops") and must allow the bank to refuse to honor a check drawn for any other purpose. The court explicitly stated "working capital" is too broad a purpose to qualify as a special draw account. The court also said special draw accounts must have language in the contract stating the borrower may use the proceeds "for no other purpose" and the bank has the right to "cancel or refuse to cash any check or checks drawn on the account for other purposes." However, the court warned a bank that merely having the contractual right to refuse a check is not enough. Bank employees must actually have the authority to refuse to cash a check, and the bank must have some

mechanism for verifying whether the borrower drew the check for the limited use permitted by the account.

So, how can a bank learn from this third lesson? First, language limiting the use of the loan proceeds to a specific purpose should be considered for automatic draw account loans. Second, the accounts should always give the bank the contractual authority to refuse a check not drawn for the permitted limited purpose. Third, the loan contract should require the borrower to always indicate the purpose of a check in the memo line of a check (banks should even consider issuing checks with the purpose pre-printed on them and make it an Event of Default to write the check for any other purpose). Ideally, the bank should verify the purpose written on the check at the same time the bank verifies whether the borrower has enough of the loan remaining to honor the check. Nevertheless, even if the bank does not verify each check, these steps should help a bank argue that an automatic draw account is a special draw account not subject to garnishment.

The Effect on Other Types of Accounts

The *In re Southwestern Glass Co.* case will impact other types of accounts besides commercial automatic draw accounts since many types of accounts have an automatic draw feature. For instance, many otherwise normal consumer checking accounts have overdraft protection. Overdraft protection is an automatic draw feature because it obligates the bank to extend credit to pay a check written on an overdrawn account. A bank therefore needs to consider how it will address other types of accounts with automatic draw features.

The key is to automatically freeze or terminate any automatic draw features as soon as a garnishment arrives. A bank cannot cutoff its liability for a garnishment until all automatic draw features are shut down. For instance, suppose a customer has one checking account at a bank with $500 balance. If the bank is served with a garnishment arising out of a $2,000 judgment, then the bank must turn over the $500 in the account and the customer remains liable for $1,500. If the account does not have an automatic draw feature, then the bank's potential liability is over once the bank answers the garnishment and turns over the $500. However, if the account has an automatic draw feature, then the bank has continuing liability if the customer writes a check on the account. Therefore, it is important to include a provision in all accounts with an automatic draw feature that allows the bank to either terminate the account or suspend the account pending the lifting of the judgment.

Was the Decision Right?

It bears mentioning the Eighth Circuit Court made this decision by trying to interpret Arkansas, as opposed to federal law. Ultimately, the Arkansas Supreme Court is the final arbiter of Arkansas law. The Arkansas Supreme Court has never ruled on this issue and if it ever took a contrary stance to the Eighth Circuit, which the Court is free to do, then the Arkansas Supreme Court's ruling would become the law in Arkansas. Indeed, there are good reasons the Arkansas Supreme Court should interpret the law different from the Eighth Circuit's decision, though admittedly the Arkansas Supreme Court is unlikely to break with the precedent established by the Eighth Circuit.

In re Southwestern Glass Co. probably was wrong on the facts and the law. First, even though Bank of Arkansas' answers to the interrogatories were not completely truthful, the answers were not exactly a lie either. At the time the bank answered the interrogatories, the bank's response that the draw account had a zero balance was technically true, albeit somewhat evasive. While the bank should have fully explained the true nature of the account, arguably the bank's answer was not egregious enough to warrant imposition of such a harsh penalty.

Second, an automatic draw account should not be subject to a writ of garnishment. The law is clear that lines of credit are not subject to garnishment; only the proceeds of loans are garnishable. In other words, if a customer has an available line of credit, a judgment creditor cannot force the bank to extend funds from the line of credit to pay the garnishment. Conversely, if a customer has loaned money in his account when the writ of garnishment arrives, then the loaned money is garnishable as "proceeds" of the loan. However, a garnishment cannot reach loan proceeds which the bank has already paid to other creditors. The bank's process of first transferring the money to the automatic draw account then honoring a check was, in substance, merely a technical operations mechanism. The economic reality of the transaction was the bank paid the funds directly to the other creditors of the borrower, which was a non-garnishable transaction. The court allowed a technical formality to dictate over economic reality.

In this case, the court decided the money was proceeds for the split second the money was in the account before payment of the check. The better result would have been to ignore the draw account as a mere a technical operations mechanism to directly pay the loaned funds to other creditors. The court's decision ignored the substance of the

transaction by garnishing money only technically in the hands of the borrower for a brief instance.

Nevertheless, despite the criticism which *In re Southwestern Glass Co.* is subject, the case is now established precedent which banks cannot ignore. It is worth noting that the case, and the suggestions in this article, applies not only to garnishments but also tax levies or any other legal process that seizes or attaches funds in an account. By following the three simple lessons outlined in this article, a bank can save itself a great deal of time, trouble and money. Regardless of whether a bank offers commercial or consumer automatic draw accounts, *In Re Southwestern Glass Co.* still offers valuable lessons. Perhaps the single greatest lesson from the case is this: Treat all legal proceedings (no matter how mundane or routine) with respect and if in doubt, seek legal advice.