The Right of Setoff-
What Does a Banker Need to Know?

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Right of Setoff-What a Banker Needs To Know

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I. Right of Setoff- Legal Requirements

The Right of Setoff (also referred to as “offset”) developed in the United States as the equitable act of deducting an amount owed by a party from an amount that is due to be paid to that same party. For example:

John has a savings account at First City Bank with a balance of $1000 (John is a creditor, the bank is a debtor). John owes First City Bank $1000 on a loan (John is a debtor and the bank is a creditor). If John fails to pay the $1000 loan, First City Bank can set off the $1000 it owes to John on the savings account against the $1000 John owes the bank. The net effect is that both obligations are zeroed out.

Setoff requires that there be a mutuality of debt, meaning that the same parties are involved in both obligations, with each party being the creditor in one obligation and the debtor in the other. Setoff also requires that both obligations be liquidated (reduced to cash) and mature (due to be paid). All three requirements must be met for setoff to be permitted.

II. Contractual Right of Setoff

The bank’s ability to exercise its right of setoff is typically found in the underlying documents executed between the bank and its customer in a banking transaction. For example, a provision found in a promissory note might be:

“Setoff. The borrower agrees that the bank may set off any amount due and payable under this note against any right the borrower has to receive money from the bank. The ‘right to receive money from the bank’ means:
- any deposit account balance the borrower has with the bank;
- any money owed to the borrower on an item presented to the bank or in the bank’s possession for collection or exchange; and,
- any repurchase agreement or other nondeposit obligation.”
‘Any amount due and payable under this note’ means the total amount of which the bank is entitled to demand payment under the terms of this note at the time the bank sets off. This total includes any balance, the due date for which the bank properly accelerates, under this note.

If the borrower’s right to receive money from the bank is also owned by someone who has not agreed to pay this note, the bank’s right of setoff will apply to the borrower’s interest in the obligation and to any other amounts which the borrower could withdraw without the consent or permission of other owners. The bank’s right of setoff does not apply to an account or other obligation where the borrower’s rights arise solely in a representative capacity. It also does not apply to any Individual Retirement Account or other tax-deferred retirement account.

The bank will not be liable for the dishonor of any check when the dishonor occurs because the bank has set off this debt against any of the borrower’s accounts. The borrower agrees to hold the bank harmless from any such claims arising as a result of the exercise of the right of setoff.”

A sample setoff provision may also exist in a deposit agreement. It could state something like:

“The bank may use funds in the depositor’s account to repay any debt which is due without notice to the depositor (other than indebtedness incurred through the use of a credit card). The bank will not be liable for dishonoring items where the exercise of the right of setoff results in insufficient funds in an account. The funds in a joint account may be used to repay the debts for which any one of the account owners is liable, whether jointly with another or individually. Notwithstanding anything to the contrary in state law, the bank is authorized at any such time to charge any such debt against the account, without regard to the origin of deposits to the account or beneficial ownership of the funds.”

These contractual provisions are designed to give the bank the specific right of setoff, regardless of whether the right is specifically provided for in state law. Fortunately, many states give a specific statutory right of setoff to banks.
III. Statutory Right of Setoff

Even though states typically recognize some type of contractual right of setoff, not all states provide banks with a statutory right of setoff. An example of a statutory right is found in Kansas, which provides at KSA 9-1206 that:

“9-1206. Set off. Any bank shall have the right to set off any obligation or claim which it has, when the same is matured against any depositor.”

This statutory right is a safety net for banks. It specifically provides banks with the ability to exercise the right of setoff, even if the specific documents involved in a transaction do not provide the right. (Attachment A has a listing of the setoff laws found in various states. Some states do not have specific statutes, but instead, have developed the right of setoff in case law. This would be considered sufficient to give the power to banks.)

IV. Establishing the Right of Setoff

a. What is “the mutuality of debt”?

The mutuality of debt requires the parties involved in the setoff action be the same. It requires that the bank is the creditor in one obligation and the debtor in the other; and the same customer is the debtor in one obligation and the creditor in the other.

For banks, this means that setoff can not be exercised when two different customers are involved. For instance, if John Doe owed the bank money on a loan, the bank is not permitted to exercise setoff by taking money from an account for which John Doe is not an owner. If John is the signer on an account held by John’s Auto Shop, Inc., that account can not be used to set off against the loan owed by John personally because a separate incorporated entity owns the account. On the other hand, if John had a sole proprietorship account titled John Doe, d/b/a John’s Auto Shop, that account could be used to set off against John’s personal loan because the sole proprietorship account is legally held by John. Vice versa, if the loan is owed by John’s Auto Shop, Inc., only deposit accounts owned by the incorporated entity are subject to setoff.

Jointly-owned accounts can be a challenge for a bank wanting to exercise setoff. The bank will want a specific provision in the deposit
**agreement** that will allow the bank to exercise setoff between individually-owned debts and jointly-owned accounts. The provision should state that each owner consents to the right of setoff, even if the debt involved is only owed by one of the owners. As an example, if John Doe owed the bank on a personal loan, the bank would be permitted to exercise setoff against an account owned by John or Mary Doe as joint tenants, even though Mary was not obligated to pay the loan.

If the bank’s deposit agreement fails to have each account owner consent to the right of setoff, then the bank’s ability to exercise setoff may be limited to the borrower’s pro-rated share of the deposit account. The theory is that the act of setoff “severs” a joint tenancy account and turns it into a tenants in common account, so that the right of setoff only applies to the tenant’s pro-rated share of the account balance.

This is why it is imperative for a bank to have the contractual right of setoff covered in deposit agreements, as well as loan agreements.

b. What is a **liquidated obligation**?

A liquidated obligation is one in which the exact amounts involved can be determined through a mathematical calculation. For banks wanting to exercise setoff, this is not a difficult requirement to satisfy since bank balances and loan indebtedness are definitively determined.

c. What is a **mature obligation**?

A mature obligation is one which is due and owing. This is sometimes the most difficult requirement for lenders to satisfy. To achieve this, a lender must prove that the amount owed on the loan is actually due to be paid by the customer. This might mean the loan is in default (either for failure to make a payment or other non-performance) or the loan has reached its maturity date and is due to be paid.

i. **Missed payments** and the **acceleration clause**

Part of the issue of determining whether a bank has a mature obligation is whether or not the bank has exercised an acceleration clause. What is an acceleration clause? It might look like the following:

*“If the borrower is in default on the loan or any agreement securing the loan, the bank may make unpaid principal, earned interest and all other agreed charges owed immediately due and payable.”*
When a payment is missed, only that missed payment is due to be paid. For a lender to consider all future payments to be due and owing, it must take steps to accelerate the debt. An acceleration clause in a mortgage or note will allow a lender, as a result of the borrower’s default, to deem all future payments due and owing immediately, even if they are not technically due.

An example of how this works is as follows:

John Doe has a car loan with First City Bank. The note says that he will make sixty monthly payments to the bank of $400.00 on the 15th day of each month beginning March 15, 2010. John makes his payment on March 15, April 15 and May 15. John misses his June 15 and July 15 payments. If, on July 25, the bank tries to collect on the past due obligation, it can only collect on the amount that is due and owing, the June 15 payment and the July 15 payment. Future payments are not yet due, and therefore cannot yet be collected. With an acceleration clause, those future payments are deemed to be immediately due and payable, allowing the bank to collect the entire remaining amount due on the loan.

In setoff situations, a bank needs to confirm that it has a right to accelerate the obligation so that it can apply setoff funds to the entire remaining obligation, rather than just the missed payments. Failing to confirm this will mean the bank can only use setoff funds to satisfy missed payments. If default exists for reasons other than missed payments (such as failing to provide insurance), an acceleration clause is mandatory since there would be no missed payments due and owing (see below).

ii. Other reasons for default

A mature obligation might also be a loan that is in default for reasons other than a missed payment. If the borrower has failed to honor other terms and conditions of the loan, such as destruction of the collateral, failure to provide financial statements or failure to maintain insurance, a default may exist under the terms of the note. If this occurs, the bank would still need to take steps to accelerate the indebtedness due under the note (as discussed above).

When dealing with consumer loans subject to the Uniform Consumer Credit Code or other state consumer lending laws, a bank must use extra
care when considering whether to exercise setoff as a result of a non-payment default. Many states limit the definition of default on a consumer loan to the following:

1) Failing to make a payment when due; or,
2) A substantial impairment in the prospect for payment, performance or realization of collateral.

If the borrower has failed to fulfill a non-payment obligation under the note, the bank will be required to prove the non-performance equates to a default before setoff will be permitted.

d. Is notice required?

There is typically no statutory requirement to send notice that the bank intends to exercise setoff. In fact, logic would dictate that notice would be counter-productive since most customers would remove the money from the account before the action was scheduled to be completed.

Instead, a bank should consider sending a more general default notice that specifically states the bank may take any action permitted under state law or the loan agreement. This type of generic language puts the customer on notice that setoff might be the remedy the bank chooses to satisfy the debt since the right of setoff is typically found in the bank’s agreements, and frequently is supported by state law.

If a bank does choose to send specific notice that it is planning to exercise its right of setoff, it may want to put an administrative hold on the subject account to prevent the customer from taking the money and closing the account (however such action could result in adverse consequences to the bank. The bank should seek the advice of legal counsel before taking such action).

V. Limitations to the Right of Setoff

a. Authorized signers are not owners

It is important for a bank to remember that a party who is an authorized signer, attorney in fact, trustee or other agent of an account holder is not the owner of an account. If that authorized signer owes a personal debt to the bank, the bank is not permitted to set off against funds held in
accounts owned by others, where the agent is merely an authorized signer. For example, if John Doe’s loan is in default, the bank will not be able to exercise a right of setoff against an account for which John is an authorized signer or power of attorney. Similarly, if an account for which John is an authorized signer is overdrawn, the bank would not be able to exercise setoff against John’s personally-owned accounts.

b. Setoff prohibited on credit card debt

Section 169 [§1026.12(d)-Regulation Z] of the Truth in Lending Act prohibits a bank from exercising its right of setoff by taking a credit card holder’s deposit balances and off-setting them against the credit card holder’s indebtedness arising in connection with a consumer credit transaction, UNLESS:

- Such action was previously authorized in writing by the cardholder as part of the plan agreement, whereby the cardholder agreed to make the periodic payments by debiting the deposit account; AND,

- Such action with respect to any outstanding disputed amount is not taken.

What does this mean? Unless the credit card holder has preauthorized debits from a deposit account to make payments to the credit card AND the amount due is not subject to a dispute, the lender is prohibited from exercising the right of setoff.

This provision becomes more disconcerting when a debit card becomes involved with a line of credit. The issuing of a debit card that can access a line of credit can turn that debit card into a credit card when drawing against the line of credit [see the Regulation Z Staff Commentary at §1026.2(a)(15)]. As a result, any amount owed under the line of credit would appear to become a “credit card plan” balance, and subject to the setoff prohibition.

The Staff Commentary for §1026.12(d) states as follows:

“Types of indebtedness; overdraft accounts-

. . . The prohibition also applies to balances arising from transactions not using the credit card itself but taking place under plans that involve credit cards. For example, if the customer writes a check that accesses an overdraft line of credit, the resulting indebtedness is subject to the offset prohibition since it is incurred through a credit card
plan, even though a consumer did not use an associated check guarantee or debit card.”

c. Setoff and Individual Retirement Accounts (IRAs)/Health Savings Accounts (HSAs)

Most state laws prohibit exercising setoff against IRAs by creditors. This prohibition is found in the state’s property exemption statutes. It is important to note, though, that in most states, the statutes protecting IRAs from setoff do not typically apply to HSAs.

Despite the fact HSAs may not be specifically exempt from setoff, there could be other problems with exercising setoff against an HSA. One problem could be meeting the “mutuality of debt” test. Technically, while the individual may owe the debt, the HSA is not owned directly by the individual, but rather it is owned in a custodial or trustee relationship, with the bank serving as the custodian or trustee. The debtor and creditor are not identical (see “mutuality of debt” above).

Furthermore, it could be considered a conflict of interest for a bank to exercise setoff against an account in which the bank also serves as custodian or trustee, such as with a HSA.

For these reasons, the bank should consult legal counsel prior to taking any such action against an HSA.

d. Setoff and Federal Benefit Payments

Federal law prohibits the attaching or garnishing of federal benefit payments, such as social security or VA benefits. The 10th Circuit Court of Appeals (in Tom v. American Credit Union, 151 F3d. 1289, 1998) extended the prohibition to a lender’s right of setoff. Therefore, a lender operating within the 10th Circuit is barred from exercising setoff against federal benefit payments. Some states also have laws prohibiting such setoff actions as to federal benefit payments. A financial institution operating outside of the 10th Circuit should not exercise its right of setoff against such benefits without the advice of legal counsel.

e. Setoff and the Statute of Limitations

State laws limit the time a bank can attempt to collect a debt. Typically, this time will be established by state statutes, and will be dependent
upon the type of debt owed by the customer. Under the Uniform Commercial Code, a six-year statute of limitations exists on promissory notes. This means, on a promissory note payable at a definite time, an action against the customer must commence within six years from the due date or the acceleration date, whichever is earlier. For demand notes, action must commence within six years after demand has been made. For all other obligations, the statute of limitations will normally be a length of time set by state law as long as the obligation is payable under a written agreement (such as a deposit or safe deposit contract). These statutes of limitations will vary from state-to-state.

Generally, collection action (such as exercising the right of setoff) is prohibited on a debt after the statute of limitations has expired. The statute of limitations can be “tolled” (will not run) for any time period that the customer leaves the state or is disabled.

f. Competing claims

1. **Garnishment v. setoff**- Can a bank exercise setoff when it receives a garnishment order on the same customer? Whether or not the bank can (or should) exercise setoff will be based, first, upon a state’s laws, and second, upon whether the bank can prove the customer’s debt is mature and whether the bank will take immediate steps to apply the setoff amount to that debt.

As discussed above, it is up to the bank to prove that the debt owed by the customer has matured. This means that the debt is either in default or the maturity date has been reached. If the customer is not past due, then the loan will not typically be in default. Most commercial loan agreements, though, will have a provision that states a garnishment or attachment action against the customer is a basis for declaring a default. Therefore, the mere fact that the customer was garnished may constitute default, even on an otherwise current loan.

As discussed previously (see “Other reasons for default”), consumer loans subject to the Uniform Consumer Credit Code or other state consumer lending law may prove to be more challenging. Presuming the loan payments are current when the garnishment is received, a lender will have to prove that the garnishment has caused some other form of default. It will be up to the lender to prove that a garnishment is truly impairing the prospect for payment or performance on the loan. If the customer has significant assets that are not affected by the garnishment, impairment will be difficult to prove. If the customer’s only assets are subject to the garnishment, impairment is not as difficult to substantiate.
Once the bank is able to prove the loan is in default, the second step is to actually apply the subject funds to that loan. Be careful, many state laws require the bank that claims a right of setoff to apply the amount in the account to the indebtedness owed when it is served with a garnishment. This means the bank has to act. It cannot declare a right of setoff in the garnishment answer, and then not actually perform the act of setoff.

2. **IRS Tax Levies** v. setoff- In IRS Revenue Ruling 2006-42, the IRS stated that a financial institution which believes it has a superior right of setoff versus an IRS tax levy should raise its setoff claim directly with the IRS prior to exercising the right of setoff. The claim can be raised informally by contacting the IRS issuing office or it can be raised formally by filing an objection within 9 months of the levy’s issuance.

3. **Security interest** v. setoff- Most states say that setoff is ineffective against a secured party that holds a security interest in a deposit account which has been properly perfected under a control agreement if the setoff is based on a claim against the debtor. Therefore, in most states, a bank will not have a superior right of setoff versus a creditor who has taken the same account as collateral and has properly perfected its interest with a control agreement.

4. **Bankruptcy** v. setoff- When a customer files for bankruptcy relief, an “automatic stay” is put into place prohibiting creditors from taking collection action against the customer. Section 553 of the US Bankruptcy Code preserves the bank’s right of setoff, though. To exercise the right of setoff, the bank must prove that its claim is a pre-petition debt owed by the debtor that is valid under the law (bankruptcy and otherwise). Next, the United States Supreme Court advised banks how to exercise the right of setoff despite the automatic stay in the case of *Citizens Bank of Maryland v. Strumpf*, 116 S. Ct. 286 (1995). The Supreme Court stated that the bank is permitted to place a temporary administrative freeze on the portion of the debtor’s bank account that is needed for the setoff action. However, the bank is required to take immediate steps to have the automatic stay lifted by the bankruptcy court before actually taking the money from the account and applying it to the debt owed. If immediate steps are not taken to have the automatic stay lifted, there might be a presumption that the bank’s freeze is not “temporary” and the bank might be deemed to have violated the automatic stay (resulting in possible court sanctions).
5. **Certified checks** v. setoff - If a bank has certified a check drawn against the customer’s account, it will have to honor that item over its own right of setoff. In other words, if the bank exercises setoff against funds already set aside for a certified check, it will still have to pay that check.

**g. Medicare receivables** and setoff

Medicare will sometimes require a physician to obtain a written statement from his or her bank that the bank waives its right of setoff against any of the physician’s accounts receiving Medicare payments. If the bank signs this statement, it will be contractually prevented from exercising its right of setoff against such accounts.

**h. Undeposited (cashed checks) and setoff**

Frequently, a bank cannot set off because the defaulting borrower has no funds in his/her deposit account. If that borrower wants to cash a check payable to the borrower and drawn on a third party, can the bank take the check and use the funds for setoff instead of providing cash back? Because “setoff” is a procedure that requires very specific tests to be met, it is questionable whether the right exists. Unless the funds are actually deposited to an account owned by the customer, the “mutuality of debt” test would not appear to have been met (where the bank and borrower are debtor/creditor in the two relationships). Furthermore, it is unlikely that a court would uphold a bank’s right to keep the proceeds of a check by refusing to provide the requested cash. At the very least, it will look like the bank tricked or threatened the customer into presenting the check for payment; at the worst, it will look like the bank stole the money. While there is no law covering this situation, banks should carefully consider the ramifications of such action and should seek the advice of legal counsel before acting. **Note: In July 2013, the FDIC assessed a $100,000 penalty against First Federal Savings Bank of Elizabethtown, Elizabethtown, Kentucky, in part for violating the UDAP prohibition in section 5 of the FTC Act, citing a practice of collecting alleged debts from non-deposit holding customers attempting to cash checks with the bank, by confiscating check proceeds without the consumer's consent and without legal process.**
i. **Death, Payable on Death Accounts and Right of Setoff**

A bank should have the right to setoff against funds owed to the decedent for debts owed by the decedent to the bank. On a multiple party account, the amount that can be set off is the proportionate amount the decedent owned of the account prior to death (normally an equal share if not otherwise defined), unless the bank specifically contracted to setoff against the entire balance of the account in its account agreement. It is always advisable to notify the estate administrator of said action and to consult with local counsel. If there is a Payable on Death (POD) beneficiary on the account, the bank should consult with local counsel to ensure that state law will permit setoff of the decedent’s death against the account formally held by the decedent. There is only one known case on this issue (out of Ohio), and it upheld the bank’s right to exercise setoff on a payable on death account at the owner’s death. The theory used is that the payable on death beneficiary’s interest in the account is only as great as the original owner’s interest. As a result, since the original owner’s interest would be subject to the bank’s setoff right, the beneficiary is subject to the same action. Local counsel should be consulted to confirm what is permitted by state law.

VI. **The Bank’s Liability for Wrongful Setoff**

A bank that erroneously exercises its right of setoff can incur significant liability to its customer, as well as to third parties.

a. **Liability to third parties**

A bank that wrongfully exercises setoff can be liable to third parties that have a competing interest in the funds. For instance, many state laws set out that a bank that has received a garnishment on a customer’s account can be liable to the garnishing creditor for improperly answering a garnishment or failing to deliver property to the creditor that is subject to garnishment. If the bank wrongfully exercised setoff rather than holding the funds under the garnishment, the garnishing creditor could sue the bank to recover the funds in question.

As discussed above, the bank might also inadvertently violate the automatic stay in bankruptcy by not following the setoff procedure established by the US Supreme Court in the *Strumpf* case.

Similarly, a bank could be liable to a co-owner of a deposit account against which the bank exercised a right of setoff. For instance, if a joint
tenant on a deposit account did not specifically consent to the bank’s right to setoff against the deposit account for debts owed by other account owners, then the bank might take money from the account that belonged to the joint tenant, rather than to the debtor (see the joint tenancy discussion in “Mutuality of Debt” in Section IV-a above). Taking money from the joint tenant could result in the bank being liable for the tort of conversion.

b. Liability to the customer

The Uniform Commercial Code states that a bank which wrongfully exercises setoff and then dishonors checks drawn against the customer that would have otherwise been paid, could be liable for damages suffered by the customer. Specifically, the Code states:

4-402. Bank's liability to customer for wrongful dishonor; time of determining insufficiency of account. (a) Except as otherwise provided in this Article, a payor bank wrongfully dishonors an item if it dishonors an item that is properly payable, but a bank may dishonor an item that would create an overdraft unless it has agreed to pay the overdraft.

(b) A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. Liability is limited to actual damages proved and may include damages for an arrest or prosecution of the customer or other consequential damages. Whether any consequential damages are proximately caused by the wrongful dishonor is a question of fact to be determined in each case.”

It is important to note that this Code makes it clear that the damages a bank would have to pay could include damages suffered as a result of the arrest or prosecution of the customer, or other consequential damages. It would be up to a judge or jury to determine exactly what damages were caused by the bank’s wrongful action.

VII. Conclusion

The bank’s right of setoff is a very powerful collection tool. However, if not utilized properly, it can create significant liability for a bank. A bank should not be afraid to use the right when warranted. However, in doing so, a bank should not hesitate to contact legal counsel for an opinion when there are any doubts about the propriety of the setoff action.
Setoff Scenarios

Scenario #1

Question:

Dee Fault has a checking account at your bank that is in joint tenancy with her husband, Joe. The balance in the account is $2,000.00. Dee also has a car loan at your bank that is 25 days past due. The past due payment is $250. The balance remaining due on the entire loan is $9,450. What issues should your bank consider before it chooses to exercise its right of setoff?

Answer:

1. Is Dee’s loan a consumer loan subject to the Uniform Consumer Credit Code (other consumer protection law), or is there a contractual right to cure that must be provided? If so, has a right to cure notice been sent on the loan and has the notice period expired?

2. Has the loan balance been accelerated? If not, the bank will only be able to set off the amount that is actually past due ($250.00).

3. If the bank has accelerated the loan balance, does the bank’s deposit agreement contain a provision that makes it clear the bank can take the entire balance in the deposit account, regardless of Joe’s co-tenancy interest? If not, the bank may only have a right to Dee’s pro rata interest in the account.
Scenario #2

Question:

Dee Fault is also a signer on the following savings account: Dee Fault, Custodian for Billy Fault under the Uniform Transfer to Minors Act. Can the bank exercise its right of setoff against that account?

Answer: No. The “mutuality of debt” requirement has not been met. Dee borrowed the money in her individual name, however, the savings account is not owned by her, but rather it is Billy’s property.

Scenario #3

Question:

There is a sole proprietorship business checking account at your bank titled: “Dee Fault, doing business as Dee’s Landscaping Service.” Can you exercise setoff against this account?

Answer:

Yes. A sole proprietorship account is legally owned by the individual (Dee Fault) and therefore, the “mutuality of debt” requirement has been met.
Scenario #4

Question:

Dee has a money market account titled: “Dee Fault, IRA.” Can you exercise setoff against this account?

Answer:

Probably not. IRA’s are typically exempt from setoff under state attachment laws. These accounts are also exempt from setoff under the provisions of many deposit and loan agreements.

Scenario #5

Question:

Dee is also past due on the credit card your bank issued to her. Can you exercise your right of setoff against Dee’s deposit accounts?

Answer:

Presuming this credit card was issued under the Truth in Lending Act (Regulation Z), the bank is prohibited from exercising its right of setoff on this debt.
Scenario #6

Question:

Dee and Joe have their home loan through your bank. As part of the loan, you provide escrow services. The escrow account shows a balance of $1,500. Can you exercise setoff against this account and apply the funds to Dee’s past due car loan?

Answer:

No. When a bank is serving as the escrow agent for a customer, the bank is the customer’s agent, which is a fiduciary obligation, meaning that the bank must act in the customer’s best interest, not in its own. Furthermore, the funds in the account have been designated to benefit specific parties (property tax collector and insurance company). These are not funds that are generally available for Dee’s use.