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DEPOSIT ACCOUNTS AS BANK LOAN COLLATERAL BEYOND SETOFF TO PERFECTION—THE COMMON LAW IS ALIVE AND WELL*

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* With another tip of the hat to Laurence H. Tribe. *See* Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. Rev. 52 (1987).

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I. SUMMARY

Trillions of dollars of consumer and business assets are held in deposit accounts.[1] Deposit accounts are potentially excellent collateral for financings.[2] Banks should be able to rely on deposit accounts, like virtually any other form of personal property, to minimize loan losses.

Current law, however, discourages utilization of deposit accounts as collateral. Deposit account financing is not covered by Article 9 of the Uniform Commercial Code (hereinafter U.C.C.).[3] It was intentionally excluded, because existing law was supposedly adequate.[4] Consequently, the common

1. As of January, 1989, according to Federal Reserve statistics, over $3.06 trillion were held in various types of deposit accounts in various types of financial institutions. The types of accounts to which this value was credited included demand, money market, savings, and long- and short-term time deposits. FED. RES. BULL. at A13 (April 1989).

Although the analysis herein could be applied to consumer and business bank customers alike, many of the theoretical and policy justifications on which this analysis rests assume a competitive market and bargaining power, neither of which may exist with respect to the typical consumer. Moreover, with respect to consumer accounts special legal problems not considered herein can arise. At times, for example, consumer hypothecation requires different and greater disclosure. *See, e.g.*, KAN. STAT. ANN. § 16a-3-202 (1981). In addition, the federal Truth in Lending Act, 15 U.S.C. § 1601 *et seq.* (1982) and Reg. Z of the Federal Reserve Board, 26 C.F.R. 226 (19__), both require disclosure of all "security interests" to consumers.

2. For example, deposit accounts should be even more valuable as collateral than inventory and accounts. Both of these frequently-relied-upon assets derive their value largely from the ease with which they can be converted into cash or its equivalent. A deposit account is already a cash equivalent. *See* Phillips, *Flawed Perfection: From Possession to Filing Under Article 9—Part I*, 59 B.U.L. REV. 1, 47 (1979) [hereinafter Phillips].

3. *See* U.C.C. §§ 9-104(i) (excluding setoffs); 9-104(l) (excluding interests in deposit accounts except as proceeds).

4. U.C.C. § 9-104 comment 7 states: "Rights under . . . deposit accounts, are often put up as collateral. Such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law."

law was (and is) the principal controlling body of law.[5]

Unfortunately, notwithstanding the assertion of the drafters of the U.C.C., the common law was not entirely adequate. While it contained the seminal doctrinal elements necessary to facilitate deposit account financing, the common law was mired by conceptually limited, confusing and antiquated understandings of the nature of deposit accounts. These defects undermined the ability of the common law to accommodate the legitimate and reasonable desire of banks and their customers to fully and flexibly use deposit accounts as collateral.

To illustrate, consider instances where banks contemplate extending credit to borrowers who are also depositors.[6] Such credit decisions depend upon the projected earnings of borrowers and the other assets which are likely to be available in case of default.[7] Among the assets banks would want to be able to count on are borrowers' deposit accounts. But can they? The ability of banks to satisfy this reasonable desire was and is currently uncertain in most jurisdictions.[8]

This official explanation of the exclusion of deposit accounts leaves much to be desired. Unfortunately, there is no complete published authoritative historical source providing that rationale. What materials there are suggest that deposit accounts were excluded largely for political reasons in light of the vociferous opposition to the U.C.C. on the part of banks and their counsel. *See* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 10.7, at 315-16 (1965) [hereinafter GILMORE]; XII C. WILLARD, THE HISTORY OF THE UNIFORM COMMERCIAL CODE, documents 23, 27, 36, 37 and *passim* (unpublished private history of U.C.C. on file in the New York library of Davis, Polk & Wardwell) [hereinafter WILLARD]. While the intent was to leave pre-U.C.C. law controlling, the implications of excluding both deposit accounts and set-offs were not thoroughly thought through. *Id.* Professor Gilmore predicted that notwithstanding the exclusion of deposit accounts, the developing common law rules might tend to become "identical with the statutory rules." 1 GILMORE, *supra*, § 10.7, at 315.

5. U.C.C. § 1-103 (except as displaced by the UCC, the principles of law and equity apply). *See, e.g.*, Trust Co. v. United States, 735 F.2d 447 (11th Cir. 1984); Gillman v. Chase Manhattan Bank, 73 N.Y.2d 1, 534 N.E.2d 824, 537 N.Y.S.2d 787 (1988); Duncan Box & Lumber Co. v. Applied Energies Inc., 270 S.E.2d 140 (W. Va. 1980).

6. Throughout this article the term "bank" is used in a general sense, with no intent to distinguish among the various types of institutions which both accept deposits and make loans. For the purposes of this article, all are generically referred to as banks.

While the common law principles discussed herein would seem to be susceptible to application to non-bank creditors, the scope of this inquiry has been limited to banks. Non-bank creditors present potentially complex additional considerations given, among other things, their lack of inherent control over deposit accounts. *See* McLaughlin, *Security Interests in Deposit Accounts: Unresolved Problems and Unanswered Questions Under Existing Law*, 54 BROOKLYN L. REV. 45 (1988) [hereinafter McLaughlin]. Non-bank creditors may not carefully monitor debtors' deposit account financial activity. *See*, Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982) [hereinafter Levmore]. Without a centralized notice filing system non-bank creditors are not in a good position to provide prospective creditors with adequate notice of their security interest. Perfection of non-bank creditors' interests in deposit accounts is not considered in this article. *See generally*, McLaughlin, *supra*.

7. *See* Baird, *A World Without Bankruptcy*, 50 LAW & CONTEMP. PROBS. 173, 175-76 (1987).

8. *See, e.g.*, Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548 (2d Cir. 1976) (applying

Generally, the common law mechanisms available to accommodate finance bargains providing for the use of deposit accounts as collateral are not clearly understood. This is especially true with respect to the creation of security interests in deposit accounts as original collateral.[9] Such security interests are achieveable under the common law through assignment and pledge, conceptually the common law equivalent of creating and perfecting a security interest in personal property under the U.C.C.[10] Some courts and commentators still believe this financing option cannot be accommodated by the common law without an antiquated formalism, the incorporation of deposit accounts into indispensable instruments like certificates of deposit.[11] Moreover, this anemic view of the common law is compounded by the frequent misconception that the totality of deposit account financing is subsumed under common law setoff[12] or banker's lien.[13] This misconception leads many to structure and interpret transactions without a clear understanding of the doctrinal differences—advantages and disadvantages—among the various methods of relying on deposit accounts as collateral. Thus, both formalism in the common law, and the frequent failure to appreciate the potential differences within the underlying doctrines, lead

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New York law); *In re* Amco Prods., Inc., 17 Bankr. 758, 762 (Bankr. W.D. Mo. 1982).

9. The interest in deposit accounts as "original collateral" is to be distinguished from security interests in deposit accounts as the proceeds from the disposition of other collateral. *See, e.g.*, McLaughlin, *supra* note 6, at 48; Zubrow, *Integration of Deposit Account Financing into Article 9 of the Uniform Commercial Code: A Proposal for Legislative Reform*, 68 MINN. L. REV. 899, 907 (1984) [hereinafter Zubrow]. *See also* U.C.C. § 9-306; Tri-State Envelope v. Americans with Hunt, Inc., 688 F. Supp. 769 (D.D.C. 1988).

10. *Compare* U.C.C. §§ 9-203, 9-302 *with* U.C.C. § 9-306.

11. *E.g.*, *In re* Amco Prods. Inc., 17 Bankr. 758, 761-62 (Bankr. W.D. Mo. 1982); Kruger v. Wells Fargo Bank, 113 Cal. 3d 352, 521 P.2d 113, 113 Cal. Rptr. 449 (1974); McLaughlin, *supra* note 6, at 82; Ahart, *Bank Setoff Under the Bankruptcy Reform Act of 1978*, 53 AM. BANKR. L.J. 205, 211-12 (1979) [hereinafter Ahart]; Murray, *Banks Versus Creditors of Their Customers: Setoffs Against Customers' Accounts*, 82 COM. L.J. 449 (1977) [hereinafter Murray].

12. Setoff is an ancient right, originating in the period of the Roman Empire, which exists when a creditor both owes and has a claim against another person. *See generally* Comment, *Automatic Extinction of Cross-Demands: From Rome to California*, 53 CAL. L. REV. 224, 227 (1965) [hereinafter Comment].

13. The "banker's lien," like the setoff, arises by operation of law. Unlike setoff or perfection, however, the banker's lien is a charge against all tangible and quasi-tangible property of the customer in the bank's possession, such as securities or commercial paper. The banker's lien properly has been said *not* to attach to the customer's chose in action against the bank arising out of the deposit agreement itself. *See* Note, *Banking Setoff: A Study in Commercial Obsolescence*, 23 HASTINGS L.J. 1585, 1586-87, nn. 8-10 (1972). *See also* 5A MICHE, MICHE ON BANKS AND BANKING § 165 (1983).

"[I]t is wrong to equate set-off and banker's lien because one cannot have a lien in property he owns. A lien by definition is a claim against property owned by another, and since the bank owns the money deposited in the customer's account it cannot have a lien on it." Murray, *supra* note 11, at ___; 5A MICHE, MICHE BANKS AND BANKING § 323, at 752 (6th ed. 1928). *See also* Meyer v. Idaho First Nat'l Bank, 96 Idaho 208, 209-10, 525 P.2d 990, 991-92 (1974); Ingram v. Liberty Nat'l Bank & Trust Co., 533 P.2d 975, 977 (Okla. 1975).

many practitioners to poorly structure deposit account financings and many courts to misinterpret and resist them even when appropriately structured.

This article clarifies "the typically muddle-headed process of thinking known as the genius of the common law"[14] with respect to deposit account financing. It reflects with greater clarity evolving doctrines of common law assignment and pledge which make perfection of security interests in deposit accounts possible in an increasing number of jurisdictions. This article advocates the conscious elaboration of these doctrines and adoption in other common law jurisdictions. Deposit account financing is just another form of private bargained for debt collateralization, and as a matter of policy, should be accomodated by the common law and given parity with Article 9 perfected security interests, provided that legitimate third party interests are protected.[15]

To bring about the intended apperception of the applicable common law principles, this article elaborates the doctrinal principles underlying deposit account financing. At its core, deposit account financing is about various manipulations of the chose in action, the intangible personal property which is the legal genesis of deposit account financing. Parts II through IV of the article are devoted to the definition, history and modern legal understanding of the chose in action and its assignment and pledge in the context of deposit account financing.[16] There are no persuasive policy arguments for

14. 1 Gilmore, *supra* note 4, § 7.3, at 202.

15. Some scholars have taken the position that statutory incorporation into the U.C.C. and reform of these common law rights is the key to greater utilization. *See* Rauer, *Conflicts Between Set-offs and Article 9 Security Interests*, 39 Stan. L. Rev. 235 (1986) [hereinafter Rauer]; Zubrow, *supra* note 9; Sepinuck, *The Problems with Setoff: A Proposed Legislative Solution*, 30 Wm. & Mary L. Rev. 51 (1988) [hereinafter Sepinuck]. While statutory reform may be desirable, it is not the focus of this article for two reasons. First, if the history of the adoption of the U.C.C. and of subsequent efforts to make comprehensive changes in the U.C.C. is any guide, such legislative action may be long in coming. In the interim, deposit account financing is underutilized. Second, before legislative amendment of the U.C.C. is undertaken, better understanding of the economic impact and policy implications of such changes should be studied. Such study can shape the contours of prudent legislation, and further conscious common law development can help provide the necessary data. *Compare* Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. Pa. L. Rev. 929 (1985) *with* Jackson & Schwartz, *Vacuum of Fact or Vacuous Theory: A Reply to Professor Kripke*, 133 U. Pa. L. Rev. 987 (1985).

Two scholars who have considered legislative changes have relied either on their own sense of what is fair and equitable, Zubrow, *supra* note 9, at 930-31, or on supposition with respect to the anticipated economic consequences, Rauer, *supra* note 15, at 250. In short, while this author concurs in the belief that secured deposit account financing is sound policy, consistent with the traditional evolution of commercial law, he also believes that the common law can and should be flexible enough to accommodate this commercial need. *See, e.g., In re* CJL Co., 71 Bankr. 261, 266 (Bankr. D. Or. 1987). Indeed, the sage Professor Gilmore predicted just such common law development. *See* Gilmore, *supra* note 4.

16. Theoretically, greater utilization of deposit account financing may be economically advantageous. It may enhance the availability of credit. "To the extent that a deposit account cannot be utilized as collateral, the debtor is deprived of a major asset on which to borrow; the

refusing to grant to deposit account financing the same protections granted to other perfected interests in other types of collateral. Even the most common policy objections to common law perfection of security interests in deposit accounts, control over deposit accounts and misleading ostensible ownership, are both manageable within available doctrine. Recent cases have accurately apprehended the nature of deposit account financing and have wisely concluded that perfected security interests in deposit accounts can be created under the common law without compromising traditional concerns with respect to secured financings.[17]

This article also reviews the common law options available to minimize loan losses. The options are setoff, debit, and perfected security interest. The relative merits of each will be compared[18] in parts V through IX.

[creditor—*inter alia*, the bank] is constrained to lend less than [it] otherwise might; and the economic effect is restrictive because potential collateral cannot be used to secure credit." Phillips, *supra* note 2, at 47. *Accord*, United States v. Harris, 249 F. Supp. 221, 224 (W.D. La. 1966) (depositor which pledged checking account "might not have been able to obtain a loan at all without some type of security").

In addition, through bank monitoring of debtor behavior while policing deposit account collateral, banks should be able to contain debtor risk-taking within bargained-for limits and to do so while realizing economies of scale. *See* Levmore, *supra* note 6; Jackson & Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143 (1979); Smith & Warner, *Bankruptcy, Secured Debt, and Optimal Capital Structure: Comment*, 39 J. FIN. 247 (1979); Meckling, *Financial Markets, Default, and Bankruptcy: The Role of the State*, 41 LAW & CONTEMP. PROBS. 13, 16-17, 30 (1977); Weston, *Some Economic Fundamentals for an Analysis of Bankruptcy*, 41 LAW & CONTEMP. PROBS. 47, 56 (1977). If this were empirically demonstrated, it would be a strong policy justification for deposit account financing. It would serve the efficiency interests of creditors and society in general by ensuring consonance between the allocation and the use of some bank credit. However, monitoring may not account for short-term secured financing; nor can it explain why parties often structure loan facilities with complex loan convenants instead of collateralizing loans. *See* Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984). As one scholar has noted, "the very existence of secured debt seems to present an insoluble problem to microeconomists . . . ." Weisberg, *Commercial Morality, the Merchant Character, and the History of the Voidable Preference*, 39 STAN. L. REV. 3, 138 (1986).

Apart from any efficiency justification, given current creditor priorities under state and federal law, greater utilization of deposit account financing could substantially reduce loan losses for banks. For example, in general, state law recognizes certain priorities for perfected securities. *See* J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE § 25-4, at 1036 (2d ed. 1980). These state law priorities generally are recognized by the federal tax and bankruptcy laws. *See infra* parts VI-IX. Thus, one of the advantages of greater common law recognition of perfected bank security interests in deposit accounts would be that it would provide an additional tool for banks to minimize loan portfolio risks.

17. *See, e.g.*, Trust Co. v. United States, 735 F.2d 447, 449 (11th Cir. 1984); Jefferson Bank & Trust v. United States, 684 F. Supp. 1542 (D. Colo. 1988); *In re* CJL Co., 71 Bankr. 261, 264 (Bankr. D. Or. 1987) Duncan Box & Lumber Co. v. Applied Energies Inc., 270 S.E.2d 140, 145-56 (W. Va. 1980). *Cf.* Peoples Nat'l Bank v. United States, 777 F.2d 459, 461-62 (9th Cir. 1985).

18. This comparison is based on five criteria: (1) the ease with which the right to use the option can be created; (2) the ease with which each option can be used; (3) the risks of each

As practitioners respond to the business impulse to make greater use of deposit accounts as collateral, more court tests of the viability of such security interests can be expected. Consistent with the development of the common law, enlightened courts should attempt to accommodate and facilitate this commercial development provided that practitioners structure deals with adequate regard for legitimate third party and societal concerns. To aid in this process, practical suggestions will be made as to how to create and maintain security interests in deposit accounts and the most appropriate circumstances for their use in the current legal environment.[19] Parts V through IX and the comments interspersed throughout the article are devoted to achieving this objective.

The article concludes that all of the necessary doctrinal elements are already in place for deposit account financing to become a reliable source to minimize bank loan losses.

II. Introduction

This section introduces and defines key concepts. Further, it summarizes the conclusions reached in this article.

A. *What Is a Deposit Account?*

The U.C.C. defines a deposit account as "a demand, time, savings, passbook or like *account* maintained with a bank, savings and loan association, credit union or like organization, ..."[20] Simply put, the U.C.C. defines a deposit account as an "account" maintained with a bank. But what is an "account"?

U.C.C. Article 9 defines "account" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance."[21] While a deposit account involves a right to payment, that right is neither for goods sold nor leased or for services rendered. Therefore, the word "ac-

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option if used before bankruptcy; (4) the strengths of each option if not used before bankruptcy; and (5) the strengths of each option if not used before attachment of a tax lien.

19. The reason frequently cited by courts for refusing to grant priority to common law perfected security interests is the technical failure of lawyers to properly structure the transaction. *See* Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548, 561 (2d Cir. 1976); *In re* Zimmerman, 69 Bankr. 436 (Bankr. E.D. Wis. 1987).

20. U.C.C. § 9-105(e) (emphasis supplied). Section 9-105(e) goes on to exclude from its definition of deposit accounts those evidenced by certificates of deposit. Certificates of deposit are *not* excluded from the term "deposit account" as used throughout this article.

The U.C.C. excludes certificates of deposit from the definition of deposit accounts in order to bring perfection of security interests in such certificates *within* the scope of Article 9. The creation and perfection of a security interest in certificates of deposit by pledge is a common law right incorporated within the scope of Article 9. U.C.C. § 9-104(l). *See, e.g.*, Rankin v. First Nat'l Bank, 416 So. 2d 738, 740 (Ala. 1982).

21. U.C.C. § 9-106.

count" as used in "deposit account" must have a meaning different from that suggested by the general U.C.C. definition.

Indeed, were it not for an explicit exclusion, a deposit account would fit within the definition of "general intangible" which means "any personal property (including things in action) other than goods, accounts . . . instruments, and money."[22] A definition of "deposit account" could read, "a demand, time savings, passbook or like [general intangible in the nature of a chose in action] maintained with a bank . . . ."[23]

This definition provides insight into the common law definition of a deposit account. Under the common law a deposit account is a species of personal property, a general intangible. It is an intangible because a deposit account does not represent a property interest in a thing (such as the bank's money), but rather the chose in action arising from a depositor's relationship to a bank.[24] This relationship is one of creditor (depositor) and debtor (bank).[25] A deposit account is a credit maintained by the bank in favor of its customer. A bank depositor owns a debt due from the bank. The common law name for such a right is a chose in action, the right to bring suit for a debt due and owing.[26]

B. *Deposit Accounts as Common Law Financing Devices*

There are three main common law deposit account financing devices: (1) setoff, (2) debit, and (3) perfected security interest. Two of these devices, setoff and perfected security interest, have variations of sufficient import in terms of their potential bankruptcy and tax consequences to give them separate names. All told, there are five devices.

1. *Setoff*

Stripped of its technical requirements, such as maturity and mutuality

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22. *Id.* (Official Comment) ("Note that this catch-all definition [of general intangibles] does not apply to . . . types of intangibles which are specifically excluded from the coverage of [Article 9]").

23. The Official Comment to U.C.C. section 9-106 recognizes that a deposit account fits within the U.C.C. definition of a general intangible. ("In some special cases a right to receive money not yet earned by performance crystallizes not into an account but into a general intangible . . . . Examples of such rights are the right to receive payment of a loan not evidenced by an instrument or chattel paper . . . . ") However, as the Official Comment to U.C.C. section 9-106 quoted in note 22 indicates, the U.C.C. does not treat a deposit account as a general intangible debt. Deposit accounts, except as proceeds, are specifically excluded from the scope of Article 9 in U.C.C. section 9-104(l).

24. *See, e.g.*, 5A MICHIE, *supra* note 13, at § 1(A); Dobyns, *Banking Setoff: A Study in Commercial Obsolescence*, 23 HASTINGS L.J. 1585, 1587-88 (1972).

25. *See* Bank of Marin v. England, 385 U.S. 99, 101 (1966); *infra* part III.

26. Significantly, what a depositor does not have is a right to claim any specific funds (money) held by the bank. Upon deposit all money held by a bank becomes part of one undistinguished commingled fund *owned* by the bank. *See* part III *infra*.

of obligations, setoff means the extinction of cross demands (choses in action) between two parties.[27] There are two important variations of setoff.

A setoff consummated before a bankruptcy petition is filed or a tax lien attaches is called a "consummated setoff." Consummated setoff also refers to a setoff which has been completed by a bank prior to the attachment of any third party interest in the deposit account.

A setoff which could have been, but was not, consummated before a bankruptcy petition was filed or a tax lien or other third party interest attached to a deposit account is called an "unconsummated setoff."[28]

The distinction between consummated and unconsummated setoff has significance in terms of bankruptcy, tax liens and other attachment of third party interests. The Bankruptcy Reform Act of 1978, as amended (hereinafter Bankruptcy Code), affords creditors (including banks) which could have made, but did not make a setoff, certain special rights, more fully discussed in part VIII. Creditors with unconsummated setoff rights have greater protection than do general unsecured creditors during bankruptcy proceedings and preferred distributional status upon plan confirmation. Moreover, certain consummated setoffs may be partially or wholly avoided by the bankruptcy trustee depending upon any improvements in position during the ninety days before bankruptcy. Unconsummated setoffs are generally immune from post-bankruptcy recapture unless there has been collusion between the bank and its customer.[29] In addition, an unconsummated setoff is not recognized at all when competing with a tax lien, while a consummated setoff has priority over a tax lien.

The status of an unconsummated setoff when in competition with other third party interests is not entirely settled. When an unconsummated setoff is in competition with a lien creditor or garnisher, the unconsummated setoff at times prevails. However, some courts have concluded that unconsummated setoff losses have priority over prior perfected conflicting Article 9 security interests.[30]

2. *Debit*

A debit is a contractually authorized device banks may use to reduce loan balances by deducting from deposit accounts amounts which corre-

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27. *See generally* CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 11.1, at 11-2 [hereinafter CLARK]; Comment, *supra* note 12.

28. In this article the term "setoff" refers to consummated setoff and unconsummated setoff, collectively. While the term unconsummated setoff is defined similarly for both bankruptcy and tax purposes, the value of an unconsummated setoff is substantial in bankruptcy and almost insignificant as against a tax lien. *See* text immediately below, parts VIII & IX *infra*.

29. *See* parts VI & VII *infra*.

30. *See* Annotation, *U.C.C.—Security Interest and Bank Setoff*, 43 A.L.R. 4th 999 (1986).

spond to amounts credited against loan balances. Although debit is in some respects similar to setoff, debit does not have certain technical requirements under the common law which setoff has, such as maturity and mutuality of obligations.[31] Conversely, debit has a requirement which setoff does not. Debit requires that the bank have pre-authorization to charge the deposit account used to minimize loan loss.[32] Setoff traditionally, and for the most part still, requires no pre-authorization by the customer;[33] the bank is entitled to setoff by operation of the common law itself.

3. *Perfected Security Interest*

A common law perfected security interest in a deposit account may assume different forms, including the pledge of an indispensable instrument (such as a certificate of deposit or savings account passbook) and the common law perfection of security interests in the intangible chose in action (*i.e.*, the debt owed to the customer by the bank). Regardless of their form, such security interests are differentiated on the basis of their ability to withstand a preference attack in bankruptcy.[34]

A non-voidable perfected security interest in a deposit balance results in "non-preferential perfection." A perfected security interest which is potentially voidable as a preference under the Bankruptcy Code results in "voidable perfection."[35]

All three devices—setoff, debit, and perfected security interest—if timely used, result in a reduction in the amount due to the bank. However, if a bankruptcy petition is filed or a tax lien or some other third party interest attaches, then different consequences can flow from the different options.

Given these definitions of the five financing options, they can be compared according to the following criteria: (1) the ease of creating the right to use the option, (2) the ease of using each option after the triggering event,[36]

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31. State law and bankruptcy maturity requirements may not be identical. As discussed more fully *infra*, given the definition of "claim" in the Bankruptcy Code, unmatured debt obligations may qualify as claims for the purposes of the law of setoff under the Bankruptcy Code but not under *most* state laws. *But see* N.Y. DEBT. CRED. LAW § 151 (Consol. 19__).

32. *See* 6 CORBIN, CONTRACTS § 1286, at 157-58 (1962) (accord and satisfaction); RESTATEMENT OF CONTRACTS § 422 (1932).

33. CLARK, *supra* note 27, ¶ 11.1, at 11-3.

34. Virtually all duly perfected security interests in deposit accounts should have priority over a tax lien which attaches after perfection. For the most part tax liens do not relate back to the time when the taxes became due. The federal tax lien operates prospectively from the time when the lien attaches. Thus, all duly perfected security interests should withstand a tax lien.

35. In this article "perfected security interest" refers to both non-preferential perfection and voidable perfection, collectively.

36. The trigger for resort to a customer's deposit balance to reduce a contemporaneous loan balance can be anything from good faith lender insecurity, to default under a loan agreement, to a voluntary or involuntary bankruptcy petition, or attachment of a lien.

(3) the risks of each option if used before bankruptcy, (4) the strengths of each option if not used before bankruptcy, and (5) the strengths of each option if not used before attachment of a tax lien.

C. *Utilization of Deposit Account Financing*

Some of the loss minimization options discussed are not underutilized. Some useful options, such as the traditional common law right of setoff and the pledging of indispensable instruments as collateral, are widely used to minimize loan losses. The device which has received the least attention is the common law perfected security interest in deposit accounts.

Secured deposit account financing has received relatively little attention for several reasons. First, secured deposit account financing is not generally well understood. Often it is lumped together with common law "setoff," a term loosely used to describe any resort to a deposit balance to reduce a corresponding loan balance.

The second reason for neglecting the perfected security interest is the misconception that a perfected common law security interest either could not be created without the use of an indispensable instrument, or if it could be created, it could not withstand a priority battle with an Article 9 perfected secured party. But the limited case law available suggests that there is no reason why any aspect of this assumption should hold true.

The belief that a bank cannot perfect a security interest in a deposit account (except through possession of an indispensable instrument), seems predicated upon a misunderstanding of the nature of deposit accounts. At times courts and commentators have indicated that it is conceptually impossible for a bank to have a security interest in a deposit account, just as one cannot have a lien on one's own property.[37] This view fundamentally misconstrues deposit account financing.

As mentioned above, the rights represented by a deposit account are *not* rights to or claims on any specific bank funds. Rather, the chose in action arising out of a deposit account is an intangible property right which is fully capable—like other intangible personal property rights—of having a security interest created in it.[38] No good reason in law or policy has been articulated demonstrating that security interests in deposit accounts should be treated differently from other common law forms of security interests in choses in action. The view that they should be treated differently as a matter of policy appears to be based on either nonsense (the impossibility of a "lien on one's own property") or some unfounded "equitable argument" to

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37. *In re* Amco Prods. Inc., 17 Bankr. 758, 762 (Bankr. W.D. Mo. 1982); Kruger v. Wells Fargo Bank, 11 Cal. 3d 352, ____, 521 P.2d 441, 443, 113 Cal. Rptr. 449, 451 (1974); Ahart, *supra* note 11, at 211-12; Murray, *supra* note 11, at 449.

38. *See* Trust Co. v. United States, 735 F.2d 447, 449 (11th Cir. 1984); Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140, 145 (W. Va. 1980).

the effect that it is unfair for *banks* in particular to be the grantees of security interests in deposit accounts.

Similarly, while the technical requirements of perfecting a common law security interest in deposit accounts by assignment and pledge are still evolving, if pertinent policy concerns are dispelled, then such security interests should withstand priority battles on the same footing as any other perfected security interests. Theoretically, a carefully established, duly perfected and seasoned common law security interest in a deposit account should prevail over its potential competitors, including, for example, judgment lien creditors.[39] Moreover, putting to one side assumptions to the contrary,[40] the special problems of notice to potential creditors can be adequately handled through contract, monitoring, and prudent bank and auditing practices.[41]

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39. The judgment lien creditor is illustrative because in general, for an unsecured creditor to get an interest in a borrower's deposit account, the creditor must first reduce his claim to judgment and then execute against the account. Also, this is the primary standpoint of a bankruptcy trustee. *See* U.C.C. § 9-301(3).

In general any security interest duly perfected under state law, common or statutory, should be able to withstand attack by the bankruptcy trustee. *See* 2 GILMORE, *supra* note 4, at § 45.2; Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1035 (1953). For the most part a bankruptcy trustee's powers to avoid a security interest are limited to those available to creditors under state law. *E.g.*, Bankruptcy Code §§ 545-546; HOUSE COMM. ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. Doc. No. 137, 93d Cong., 1st Sess. 70 (1973) ("[F]or the most part, [bargained for secured claims] should be recognized in the bankruptcy process"); *cf.* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161-63 (1946) (validity of creditor claims in general controlled by state law, unless in conflict with federal policy and equitable principles). The major exceptions to this general proposition are the special avoidance powers of the bankruptcy trustee as to "preferential transfers" and "improvements in position" made during specified periods before bankruptcy, usually ninety days. *See, e.g.*, 11 U.S.C. §§ 547, 553 (1979).

40. *See* Zubrow, *supra* note 9, at 931.

41. Both *Duncan Box* and *Wells Fargo* stress the importance of a bank's behavior in notifying subsequent creditors under the common law of assignment and pledge. The Zubrow and Rauer articles take the conventional position that notification through the Article 9 filing system is the best method of giving notice. While there is considerable merit to this approach, it has been and in some quarters still is widely believed that many creditors rely more heavily on debtors' financial statements than on centralized filing systems like that of Article 9 in making credit decisions. *See, e.g.*, Helman, *Ostensible Ownership and the Uniform Commercial Code*, 83 COM. L.J. 25, 32-33 (1978); Hanna, *The Extension of Public Recordation*, 31 COLUM. L. REV. 617, 630, 636-37 (1931). *Cf.*, Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53, 62 (1983).

Whether this is true, it is clear that the Article 9 filing system is not the *only* effective method of notifying prospective creditors. There are at least four other methods which in combination would provide notice adequate to defeat claims of good faith reliance on the depositor's ostensible unincumbered ownership of a deposit account. *Cf.* Clow v. Woods, 5 Serg. & Rawle 275, 9 Am. Dec. 346 (Penn. 1819). Notification of a common law perfected security interest could be accomplished through: (1) the name the bank gives the account—for example, "special reserve account"; (2) the specificity with which the collateral (the deposit account and its balance) is described in the loan agreement; (3) the use of a bold legend on any writing the

The final reason perfected security interests have received so little attention is that the practical aspects of establishing such interests are uncertain or cumbersome. With respect to this problem, the evolving case law offers some guidance.[42] Typical of developing common law, predictability is limited to precedent and persuasive reasoning. Until there is controlling authority available in each jurisdiction, the technical requirements of perfection will remain somewhat elusive and uncertain. This article provides as much guidance as is presently possible.[43]

D. *Summary of Conclusions*

On four of the five criteria mentioned above,[44] the traditional setoff (both consummated and unconsummated) ranks first, or near to first. Debit ranks last because of its relatively poor evaluation under criteria (3), (4), and (5). The evaluation of the perfected security interest ranks it close to setoff and clearly ahead of debit. The primary disadvantage of a perfected security interest is that it is relatively costly to establish and maintain,[45] and depending on its timing—that is, whether it is voidable in bankruptcy *vel non*—a perfected security interest may be subject to attack as a preference.

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bank issues indicating that the bank has title to the account and that the debtor has no present interest in or control over the account whatsoever; and finally, (4) a practice accepted by the bank in responding to or affirmatively advising any accountant or auditor for the debtor, that the account is encumbered and should not be treated as a cash equivalent item. Under current theories of accountant responsibility to third parties foreseeably relying on the financial statements they review, such bank notification to accountants or auditors should ensure that the bank's security interest is reflected on the debtor's financial statement (or at least shift liability to the accountants when it is not). *See, e.g.*, Shroyer, *Accountants and the Dynamics of Duty*, 13 Wm. Mitchell L. Rev. 477, 482 (1987).

42. In particular see Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140, 144 (W. Va. 1980) and the cases which have relied on this seminal case, discussed *infra*.

43. There is no reason to believe that the common law will not continue to respond to this commercial exigency as it has in the past. *See* Elliott, *The Evolutionary Tradition in Jurisprudence*, 85 Colum. L. Rev. 38 (1985). There is also no reason to believe that it will do a better job with deposit account financing than it has in other commercial areas. Legislative reform may be indicated. *See* Rauer, *supra* note 15, at 243-44, 265; Zubrow, *supra* note 9, at 1016-17. But if history is a guide, the time within which any statutory reform is likely to occur may be remote indeed. In the interim the common law can fulfill its traditional role. This article adopts the position that the contours provided by *Duncan Box* are a sound base on which other jurisdictions should build.

44. The criteria are: (1) the ease with which the right to use the option is created; (2) the ease with which each option is used; (3) the risks of each option if used before bankruptcy; (4) the strengths of each option if not used before bankruptcy; and (5) the strengths of each option if not used before attachment of a tax lien.

45. Of course, these additional costs to a bank establishing and especially maintaining perfected security interests are associated with the monitoring function. To the extent a bank performs this function and incurs these additional costs, it polices the debtor's post-agreement risk taking. It can be argued that the bank should be compensated by the creditor body through priority treatment.

Yet perfection ranks relatively well in terms of criteria (2), (3), (4), and (5) and therefore is ranked at least close to, if not ahead of, setoff.

On the whole, reliance on setoff rights is usually the bank's best recourse. In most situations there is little reason to go to the extra effort and expense of setting up a perfected security interest. However, where the bank is concerned that the technicalities alluded to above (for instance, lack of mutuality) may defeat the right of setoff or that bankruptcy, a tax lien or some other third party interest may attach as a surprise, non-preferential perfection may be best because it is already in place and does not require quick timing prior to a bankruptcy or the attachment of a tax lien or some other third party interest. Moreover, non-preferential perfection offers most of the advantages of unconsummated setoff.

The perfection of security interests in deposit accounts, either through the use of an indispensable instrument or through a *Duncan Box* assignment and pledge therefore has advantages and disadvantages particularly marked in bankruptcy and where a tax lien is possible.[46] The remainder of this article clarifies the legal foundations for and expands the horizons of deposit account financing by exposing its fuller possibilities under the common law.

III. The Chose in Action—The Core of Deposit Account Financing

A deposit account was defined in the introduction as "a demand, time savings, passbook or like [general intangible in the nature of a chose in action] maintained with a bank."[47] This section refines, clarifies and illustrates that definition.

It is axiomatic that when funds are transferred to ("deposited in") a general deposit account, a relationship of debtor and creditor is created.[48] At least where no expressed trust is established, the bank becomes the outright owner of the deposited funds.[49] There is no custodianship, warehousing, or bailment for the customer, or ownership of specific currency by the customer.[50] Though such terms were accurate descriptions of the early bank-

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46. *See* Trust Co. v. United States, 735 F.2d 447, 449 (11th Cir. 1984). *See generally* Duncan & Lyons, *Federal Tax Liens and the Secured Party*, 21 U.C.C. L.J. 3 (1988).

47. This adaptation of the U.C.C. definition suffices as a threshold common law definition. It is superior to the U.C.C.'s definition in that it recognizes that a deposit account is a species of debt.

48. Bank of Marin v. England, 385 U.S. 99, 101 (1966); New York County Nat'l Bank v. Massey, 192 U.S. 138, 138-39 (1904); Michie, *supra* note 13, § 1, at 1 & n.3 (federal and state cases collected); TeSelle, *Banker's Right of Setoff—Banker Beware*, 54 Okla. L. Rev. 40, 40-41 (1981).

49. *See* Marine Bank v. Fulton Bank, 69 U.S. (2 Wall.) 252, 256 (1854); Morse v. Crocker Nat'l Bank, 142 Cal. App. 3d 228, ____, 190 Cal. Rptr. 839, 842 (Dist. Ct. App. 1983) (but when funds are deposited pursuant to an express trust, the debtor-creditor relationship does not exist because of the bank's fiduciary duty with respect to the deposited funds).

50. Michie, *supra* note 13, § 1, at 9 nn.6 & 7.

customer relationship, they have not been accurate since the seventeenth century.[51]

A legacy of the bailment origins of modern banking is the notion that bank customers deposit their money for safekeeping in a bank. The description of a "deposit" of money into an account where it is "maintained" is reminiscent of the seventeenth century bailment. This is not an accurate description of a customer's relationship to its bank.[52]

A depositor is simply a species of bank creditor.[53] The bank owes its depositor payment of a debt in accordance with the terms of the deposit contract.[54] Title to the funds is in the bank, and general depositors are paid from a single commingled fund belonging to the depository institution and

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51. The best abbreviated version of this history is found in E. FARNSWORTH, COMMERCIAL PAPER 43 (3rd ed. 1984). The roots of contemporary banking are traceable to seventeenth century practice among the goldsmiths of Lombard Street in London. During this period these businesmen began accepting valuables for safekeeping. After Charles I "borrowed" 200,000 pounds from the king's mint in the Tower of London, merchants deposited their valuables with these goldsmiths in increasing numbers. The goldsmiths in turn began to make loans from these deposits. The creditworthiness of the goldsmiths became the foundation for the modern bank. In contrast to moneylenders (who made loans from their own capital), the Lombard Street goldsmiths assumed the role of financial intermediaries between savers and borrowers. In time this change was reflected in the legal relationship between goldsmith and customer. It changed from bailor-bailee to debtor-creditor.

52. Perhaps the concept of depositing valuables for safekeeping is useful psychologically, creating the reassuring, albeit misleading, impression in customers that they are depositing their money for safekeeping and can retrieve it at will. As a matter of law and economics, this impression is simply an illusion. Customers who "deposit" funds into a bank are really bank creditors and, through the intermediation of banks, lenders to other borrowers.

Yet inaccurate descriptions linger. Courts have differentiated a "loan" and a "deposit" depending on whether the customer intended to put the funds at the bank's disposal or merely used the bank as a convenient means of holding the funds. *See, e.g.*, Brigham v. McCabe, 20 N.Y.2d 525, 531, 232 N.E.2d 327, 330, 285 N.Y.S.2d 294, 298 (1967). Courts also have described the debtor-creditor relationship between customer and bank as created by the payment of money into the bank to be repaid upon demand. Gimbel Bros. Inc. v. White, 256 A.D. 439, 441, 10 N.Y.S.2d 666, 667 (1939); Wasserman v. Brodrick, 140 Misc. 174, 175, 250 N.Y.S. 84, 86 (1931). Both of these statements are misleading in the sense that they suggest a deposit is a bailment. Indeed the U.C.C. is similarly misleading.

For example, while the U.C.C. Official Comments suggest that deposit accounts are a form of intangible, the definition of a certificate of deposit refers to "an acknowledgment by a bank of receipt of money with an engagement to repay *it*." U.C.C. § 3-104(2)(c) (emphasis supplied). This definition misleadingly suggests that the deposit account underlying a certificate is a custodianship or bailment of the very same money which was deposited. *Cf.* Brigham v. McCabe, 20 N.Y.2d 525, 232 N.E.2d 327, 285 N.Y.S.2d 294 (1967).

53. *See* Katz v. First Nat'l Bank, 568 F.2d 964, 969 (2d Cir. 1977); *In re* Hecht, 41 Bankr. 701, 704 n.4 (S.D.N.Y. 1984); Peter Kiewit Sons', Inc. v. Douglas County, 172 Neb. 710, ____, 111 N.W.2d 734, 738 (1961).

54. *See, e.g.*, Schaller v. Marine Nat'l Bank, 131 Wis. 2d 389, ____, 388 N.W.2d 645, 648 (1986); Kings Premium Serv. Corp. v. Manufacturers Hanover Trust Co., 115 A.D.2d 707, 708-09, 496 N.Y.S.2d 524, 526 (N.Y. App. Div. 1985).

not to individual depositors.[55] Under the common law the sort of payment obligation created traditionally has been referred to as a chose in action.[56]

Whatever its etymology, "chose in action" now denotes a personal right not reduced to possession (*e.g.*, an intangible) recoverable by a law suit,[57] and includes debts[58] and open or unliquidated accounts.[59] In the case of a demand deposit, the bank is contractually obligated to pay the debt it owes the customer on demand.[60] Yet, as with all deposits except possibly special trust accounts, the customer's property consists of nothing more than an intangible chose in action against the bank.[61]

Against this background, the three common law loan loss minimization devices can be reconceptualized as related manipulations of choses in action. For example, when certain required conditions obtain, setoff entitles a bank to cancel, *pro tanto*, the chose in action the depositor-borrower[62] has against the bank (the deposit account) with the chose in action the bank has against the depositor-borrower (the loan). Because setoff arises by operation of law,[63] it does not require any pre-authorization.

Debit, by contrast, is an extinguishment of a deposit account chose in action upon conditions agreed to between the depositor and the bank. Debit authorizes a bank to charge a customer's account pursuant to the terms and

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55. *See* Stella Flour & Feed Corp. v. National City Bank, 308 N.Y. 1023, 1025, 127 N.E.2d 864, 865 (1955); *In re* Delany, 256 N.Y. 315, 319, 176 N.E. 407, 409 (1931); Owens v. Andrews Bank & Trust Co., 226 S.C. 490, ____, 220 S.E.2d 116, 119 (1975).

56. "Chose in action" is a term with no single agreed-upon meaning. *See* BOUVIER'S LAW DICTIONARY 483 (3d ed. 1914). It is typically defined in opposition to another term, "chose in possession." (Both phrases derive from the French word "chose" which is conceptually the same as the Latin word *res*.) A. CORBIN, CORBIN ON CONTRACTS § 859 at 790-91 (1952). "Chose" roughly translates into the English word "thing." The UCC adopts this definition in defining a general intangible when it refers to a "thing" in action. U.C.C. § 9-106. Thus, the phrase chose in possession refers to a "thing in possession," that is, a thing which is capable of being possessed and is in fact possessed. In general, such a "thing" is thought of as tangible.

57. *See* Samuels v. Public Nat'l Bank & Trust Co., 140 Misc. 744, 746-47, 251 N.Y.S. 671, 675 (Mun. Ct. 1931).

58. *See* Bushnell v. Kennedy, 76 U.S. (9 Wall.) 387, 391 (1869).

59. Sere & Laralde v. Pitot, 10 U.S. (6 Cranch) 332, 335 (1810).

60. In the case of a time deposit, the bank can, at its option, force the depositor to wait a specified minimum time before withdrawal, at least without the imposition of a legally sanctioned penalty. *See* Regulation D, 12 C.F.R. § 204.2(C)(1)(i) (1988). Regulation D defines "time deposit" in pertinent part as "a deposit that the depositor does not have a right to withdraw for a period of 6 days or more after the date of deposit."

61. Whatever the type of account, the depositor's right against the bank is a claim to a debt, a "right to sue" or a "chose in action" against the bank. *See, e.g.*, Trust Co. v. United States, 735 F.2d 447, 449 (11th Cir. 1984); *In re* Delany, 256 N.Y. 315, 320, 176 N.E. 407, 410 (1931).

62. The term depositor-borrower is used to make clear that, as the mutuality requirement for setoff mandates, an identity of parties must exist in respect to *both* the bank's and the depositor's choses in action.

63. In part for this reason, setoff is excluded from the scope of U.C.C. Article 9. U.C.C. § 9-104(i).

conditions of a contract. It is a financing tool which dedicates the deposit account to the satisfaction of the depositor's loan obligation upon the contingencies set forth in the deposit agreement. Because it arises by contract, debit is freed from the common law requirements imposed on setoff. For example, there is no mutuality requirement as there is with setoff.[64]

Finally, a perfected security interest is the most complicated of the three devices. Like debit, it is a right which arises pursuant to a contract, in this instance generally called a security agreement. This agreement grants the bank a security interest in the depositor's chose in action. This grant or transfer is effective at the time the security interest is created. Unlike debit, perfection transfers control over the account to the bank prior to default. Thus, some of the greater complexity of perfected security interests arises because of the necessity of adequately describing the collateral, which may be a fluctuating debt, and setting forth the terms and conditions on which transfer of control is based.

The chose in action concept is particularly useful in understanding debit and perfected security interests because it reveals that what the bank acquires is not an interest in its own assets, but an interest in the debt arising from a deposit. The bank acquires an interest in the (intangible) property of the depositor. The fact that the particular property interest is a chose in action against the bank itself does not disturb this analysis or lead to circularity. Two simple analogies illustrate the point.

When a corporation issues a bond, that bond evidences the corporation's debt to the bondholder. Hypothesize a situation where a person owns bonds issued by a corporation. Assume also that the person desires to borrow from that corporation. Assume further that the corporation is unwilling to lend without collateral. If the bonds the person owns are pledged as collateral, then the corporation would hold evidence of its own indebtedness as collateral for the loan. The corporation would still be indebted unless it acquired the right to foreclose on the collateral (the bonds). At that point the corporation might choose to cancel its debt obligation.

Next, hypothesize a corporation which obtains credit on account, that is, without issuing a bond or other corporal evidence of its indebtedness. A chose in action, debt, running against the corporation would be created. This intangible personal property would belong to the account lender. Now assume the lender turns borrower and obtains credit from the corporation by granting the corporation a security interest in and exclusive control over one of the assets of the lender (now turned borrower), the account. As

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64. Note that with respect to debit, the borrower and the depositor need not be the same person; this is in contrast to the requirement of mutuality in setoff. For example, the depositor might be the sales subsidiary of a corporation and the borrower the manufacturing subsidiary. Debit can be used in such a situation (where setoff would be unavailable) to minimize loan loss provided the sales subsidiary authorized the bank to charge its account in satisfaction of the manufacturing subsidiary's debt.

above, the corporation is still indebted unless it acquires the right to foreclose on the collateral, the chose in action against itself. A "pledge" has been accomplished without the issuance of an instrument. Upon foreclosure the chose in action should dissolve, but until that time it remains intact and is fully capable of serving as collateral.

Now suppose the corporation in the two hypotheticals is a bank. If the loan collateralization is accomplished by pledge of an indispensable instrument, such as a certificate of deposit, the bank has possession of a claim against itself. Until foreclosure, title to the instrument remains in the pledgor and the bank still has an outstanding debt.

If the hypothesized transfer of title and control is contingent, then an unperfected interest in the nature of a debit is created. On the other hand, if the transfer is accomplished without an instrument by establishing a *Duncan Box* "reserve account" granting a present interest in and control over the account (see sections V and VI, *infra*), the bank obtains an interest in a claim against itself as collateral for its loan to the depositor. In either case, the bank's obligation, the debt, remains intact, until the bank forecloses. Until that time what the bank has an interest in the property of its depositor functioning as collateral for a loan.

With this more refined appreciation of the three basic loan loss minimization options, it is possible to elaborate on the common law principles applicable to each device and discuss how a bank puts itself in a position to use each device.

Except for setoff, a bank may not charge or reduce the amount it owes the customer (*i.e.*, the customer's deposit account) without the depositor's permission.[65] For example, the depositor's signature on a check authorizes a charge to the customer's account when the check is duly presented.[66] To be positioned to use debit, the bank needs the depositor's prior written permission.[67]

In contrast, setoff is a non-consensual common law right which arises by operation of law.[68] Once the conditions precedent arise, such as mutuality and maturity of the cross obligations (chose in action), the bank has a common law entitlement to setoff without the customer's consent.[69] A debit is

65. *See, e.g.*, Barad v. Bank of Commerce, 48 Misc. 2d 839, 842, 266 N.Y.S.2d 273, 276 (Sup. Ct. 1966), *aff'd in part*, 27 A.D.2d 848, 280 N.Y.S.2d 908 (1967); Beech-Nut Packing Co. v. National City Bank, 149 Misc. 682, 684, 268 N.Y.S. 51, 54 (1933); Gidden v. Chase Nat'l Bank, 82 N.Y.S.2d 341, 343 (Sup. Ct. 1948); *cf.* Southern Elec. Supply Co. v. Raleigh County Nat'l Bank, 320 S.E.2d 515 (W. Va. 1984).

66. U.C.C. §§ 4-401(1), 4-104(1).

67. *See, e.g.*, Machelder v. Dembo, 100 N.Y.S.2d 972 (1949). Thus, some loan agreements routinely provide that the "bank forthwith upon the maturity of any installment of principal or interest on the Note may charge any deposit account of the borrower or any affiliate of the borrower maintained with the bank for the full amount of said Note."

68. *See, e.g.*, CLARK, *supra* note 27, ¶ 11.1, at 11-3 (1981).

69. Dobyns, *supra* note 24, at 1587 (1972). There are, however, a limited number of states

distinguished from a setoff in that the debit is a pre-authorized consensual charge to the depositor's account, while the conditions under which a setoff can be made are determined by law without regard to any customer consent.[70]

Having advance permission to debit is valuable if there are technical problems—such as lack of maturity or mutuality—which might affect the availability of setoff. Having the right to debit also may limit the right of setoff.[71]

IV. Creation of the Right to Use Each Option

A. *Preparing to Use Setoff*

The first criterion by which each loss minimization option is evaluated is the ease with which the right to use the option can be created. As dis-

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which require prior consent, which can usually be provided on the signature card. *See, e.g.*, Biby v. Union Nat'l Bank, 162 N.W.2d 370, 375-77 (N.D. 1968); CLARK, *supra* note 27, ¶ 11.1, at 11-3; LA. CIV. CODE ANN. art. 2210 (West 1953); MD. CODE COM. LAW § 15-702 (1983); N.D. CENT. CODE § 6-03-67 (1975).

70. Presently one finds a good deal of confusion in terminology in the case law on this point. Some of this confusion is engendered by the ingenuity of bank counsel in creating hybrids of the three devices. Such creativity is of course to be encouraged to maximize the use of deposit account financing. Nevertheless, conceptual precision on the part of both counsel and the courts would lead to a better understanding of how these devices can be reliably used separately and in combination. For example, where a security agreement specifically authorized a bank to apply upon default deposit balances to pay down any matured debt, it has been held that a bank may "setoff" against such deposit balances notwithstanding the fact the bank had not first exhausted its other available collateral. Frank Briscoe Co. v. Suburban Trust Co., 100 N.J. Super. 431, ___, 242 A.2d 54, 55 (Super. Ct. App. Div. 1968). And in Chickerno v. Society Nat'l Bank, 58 Ohio St. 2d 315, ___, 390 N.E.2d 1183, 1186 (1979), the court held that mutuality problems regarding setoff could be cured by contractual pre-authorization to charge the joint depositors' account. In both of these cases, the setoff right was enhanced, and freed from some of its common law restrictions, by combining setoff with debit. Such hybrids may even qualify as setoffs for bankruptcy purposes since they devolve *ab initio* from a modification of the contract which created the deposit account. *Accord*, Jordan v. Lavin, 319 Mass. 362, ___, 66 N.E.2d 41, 43 (1946)(pre-authorization to apply deposit account as collateral valid notwithstanding limitation on right of setoff).

71. *See* United Seeds, Inc. v. Eagle Green Corp., 223 Neb. 360, 389 N.W.2d 571 (1986). The court concluded that the agreement to *debit* the depositor's account in payment for matured debts and to honor overdrafts was inconsistent with the intent to exercise the right of setoff against those debts, and the *bank's right was not superior to that of a judgment creditor seeking to garnish the depositor's account* where the garnishee bank allowed checking account overdrafts and the bank was estopped from exercising its continuing right to setoff against subsequent deposits by its denial of the existence of a checking account in response to garnisher interrogatories. *Id.* at ___, 389 N.W.2d at 574. Although debit is not differentiated from setoff, this is a debit case improperly analyzed as setoff. The court looked to the intent to setoff when really the problem was that the debit had not been consummated before the garnishment and the bank's right to debit should have been cut off by garnishment. The court's estoppel analysis as to subsequent deposits was sound.

cussed above, a bank does not create, in a contractual sense, the right of setoff. Setoff arises by operation of law and may be exercised in the bank's discretion if the necessary preconditions exist. Under certain conditions and subject to certain limitations, a bank may at any time set off against a customer's deposit account if the customer at the same time owes a matured debt to the bank.[72]

For a setoff by a bank to occur, three actions by the bank are necessary: the bank must make a decision to exercise the setoff, it must take some affirmative action to accomplish the setoff, and some record must be made which evinces that the right of setoff has been exercised.[73]

Setoff may *not* be exercised if any of the following conditions exist.[74]

1. *The Mutuality Requirement*

From its roots in Roman law through its common law evolution, setoff has involved the extinction of mutual cross choses in action; the bank must owe the depositor (deposit account) and the same depositor must owe the bank (loan or other extension of credit).[75] This mutuality requirement, essential for setoff, has been defined as "that right which exists between two parties, each of whom under an independent contract owes a definite amount to the other, to set off their respective debts by way of mutual deduction."[76] The two parties must have the same respective relationship to the choses in action which are extinguished.[77] For example, if the depositor's chose in action is held by the depositor in a fiduciary or like capacity, the bank may not set off its chose in action for a non-performing loan made to the depositor in his individual (non-fiduciary) capacity. In such a circumstance, mutuality is lacking.[78]

Mutuality is lacking where either: there is no deposit liability due from

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72. *See, e.g., In re* Applied Logic Corp., 576 F.2d 952, 961 (2d Cir. 1978) (bank involved in a work-out of the depositor's debt was not estopped from setting off against the depositor's account either by inside information or by representations to other banks that it would not set off).

73. *See, e.g.*, Baker v. National City Bank, 511 F.2d 1016, 1018 (6th Cir. 1975); *In re* Davis, 29 Bankr. 652, 654 (W.D.N.Y. 1983); Clarkson Co. v. Shaheen, 533 F. Supp. 905, 925 (S.D.N.Y. 1982); United Seeds, Inc. v. Eagle Green Corp., 223 Neb. 360, 363, 389 N.W.2d 571, 574 (1986); Aspen Indus., Inc. v. Marine Midland Bank, 74 A.D.2d 59, 426 N.Y.S.2d 620 (1980), *rev'd on other grounds*, 52 N.Y.2d 575, 421 N.E.2d 808, 439 N.Y.S.2d 316 (1981). *See generally* Sepinuak, *supra* note 15, at 60 (critique of this definition as vague).

74. The right of setoff has been further limited, particularly in respect to consumer transactions, by a number of federal and state statutes. A thorough treatment of these statutes is beyond the scope of this article.

75. Comment, *supra* note 12, at 224-78.

76. Chickerno v. Society Nat'l Bank, 58 Ohio St. 2d 315, ____, 390 N.E.2d 1183, 1185 (1979).

77. *See* F.D.I.C. v. Pioneer State Bank, 15 N.J. Super. 381, ____, 382 A.2d 958, 962 (1977).

78. Clark, *supra* note 27, ¶ 11.6, at 11-18 to 11-19.

the bank to the depositor (*e.g.*, the credit for an item received subject to collection may not be due from the bank to the customer until collection—that is "final payment"[79]), or the bank actually knows or has constructive knowledge[80] that a third party has an interest in the funds on deposit (*e.g.*, the funds on deposit are proceeds of collateral in which a perfected security interest exists in favor of a third person pursuant to U.C.C. sections 9-306(1)-(4)[81] or are a trust deposit or other "special deposit").[82] The bank's liability to the depositor on an account in which a third person is known to have an interest is generally described in the case law as a liability lacking "mutuality."[83]

Thus, the bank and the customer-depositor must have cross choses in action owing to each other in the same respective capacities. A hypothetical illustration is helpful: if a sales subsidiary of a corporation was the depositor and a finance subsidiary was the borrower, there would be no mutuality even though both the sales and finance companies had the same corporate parent.[84]

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79. *See* U.C.C. § 4-213.

80. *See* Clark, *Bank Exercise of Set-Off: Avoiding the Pitfalls*, 98 BANKING L.J. 196, 215, 220 (1981).

81. *See, e.g.*, C.O. Funk & Sons, Inc. v. Sullivan Equip., Inc., 89 Ill.2d 27, 431 N.E.2d 370 (1982).

82. *See, e.g.*, Morse v. Crocker Nat'l Bank, 142 Cal. App. 3d 228, 190 Cal. Rptr. 839, 842 (1983). With respect to "reserve accounts," see United States v. Carlow, 323 F. Supp. 1310, 1316 (W.D. Pa. 1971); First City Nat'l Bank v. Long-Lewis Hardware Co., 363 So. 2d 770, 772-73 (Ala. 1978); Engleman v. Bank of America Nat'l Trust & Sav. Ass'n, 98 Cal. App. 2d 327, ____, 219 P.2d 868, 870 (1950); and Martin v. First State Bank, 490 S.W.2d 208, 211 (Tex. Civ. App. 1973).

83. Because of the problems associated with establishing the bank's actual knowledge or sufficient notice to put the bank on further inquiry, an alternative ground is relied upon in some recent cases. These cases hold that setoff rights, while excluded from U.C.C. section 9-104(i), are nevertheless subject to Article 9's priority system because setoff rights are not otherwise provided for under the U.C.C. *Compare* U.C.C. § 9-201 *with* U.C.C. § 9-306(4)(d)(i). *See, e.g.*, National Acceptance Co. v. Virginia Capital Bank, 498 F. Supp. 1078 (E.D. Va. 1980), *aff'd in part*, 673 F.2d 1314 (4th Cir. 1981). The statutory construction on which these cases rely is technically appealing but not entirely consistent with the history of the exclusion of setoff rights from the scope of Article 9. What historical evidence there is suggests that notwithstanding the language of section 9-201, the drafters of the Code simply did not consider the interrelationship of excluded setoffs and security interests perfected under Article 9. *See* 1 GILMORE, *supra* note 4, § 10.7, at 315-16. It would appear sensible to extend common law constructive notice concepts to include filed Article 9 financing statements where the nature of the debtor's business should alert reasonable bankers to the likelihood of secured accounts, inventory financing, etc. As any reasonable banker should know, such financing arrangements now customarily extend to proceeds of described collateral. Such a development would provide substantial certainty without the inflexibility of a *per se* rule subordinating setoff to Article 9 security interests. *See* State Bank v. First Bank, 320 N.W.2d 723, 725 (Minn. 1982); Republican Valley Bank v. Security State Bank, 229 Neb. 339, 341, 426 N.W.2d 529, 531 (1988). *But see* Citibank v. Interfirst Bank, 784 F.2d 619, 620-21 (5th Cir. 1986); Insley Mfg. Corp. v. Draper Bank & Trust, 717 P.2d 1341, 1344-47 (Utah 1986).

84. Use of debit or perfected security interest can avoid this sort of limitation on the right

Other interesting variations on the mutuality requirement can arise involving joint accounts[85] and accounts subject to security interests, particularly with respect to proceeds of Article 9 collateral.[86] For the purposes of this article, these complexities suggest that in order for a bank to be fully prepared to use setoff, the bank must know what steps must be taken and must also know (or be prepared to document that it did not know) the ownership of the deposit account which will be relied upon.[87] The expense of obtaining and noting such knowledge in advance of the need for setoff would be particularly justified in those circumstances where greater assurance of availability of the deposit account as a loss minimization option is desired.

2. *The Maturity Requirement*

Before a bank may setoff, it is necessary that both the borrower-depositor's obligation to the bank and the bank's obligation to the borrower-depositor be matured. Maturity is lacking either: if the debt owed to the bank by the depositor is not matured, either by its terms or by acceleration, or if the deposit owed by the bank is not matured (*e.g.*, if it consists of an unmatured certificate of deposit).

With respect to the obligation to the bank, it is fundamental that the borrower's loan obligation must be matured prior to setoff.[88] To ensure that the bank is positioned to setoff, prudent planning dictates that the bank

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of setoff. For example, through use of debit a bank can be authorized to charge an account belonging to a party other than the borrower.

85. *See* Chickerno v. Society Nat'l Bank, 58 Ohio St. 2d 315, ____, 390 N.E.2d 1183, 1186 (1979). In *Chickerno* the court did not have to determine which of the joint depositors owned the chose in action. Even though one of the two joint depositors had contributed the entire credit to the account, both had signed a joint deposit agreement allowing the joint account to be charged for obligations to the bank of either joint depositor. The actual language used in the joint deposit agreement is quoted in the opinion. This case illustrates a hybrid use of both setoff and debit. *See also* Sandler v. United Indus. Bank, 23 A.D.2d 567, 256 N.Y.S.2d 442 (1965).

86. *See* U.C.C. §§ 9-104(j), 9-306(1) & (2); C.O. Funk & Sons, Inc. v. Sullivan Equip., Inc., 89 Ill. 2d 27, ____, 431 N.E.2d 370, 372 (1982); Skilton, *The Secured Party's Rights in a Debtor's Bank Account Under Article 9 of the Uniform Commercial Code*, 1977 S. Ill. U.L.J. 120.

87. But in some jurisdictions a bank may be better off not knowing about or closely investigating title to a deposit account. In these jurisdictions, those adhering to the so-called "legal rule," the bank *may* be able to claim it did not have actual or circumstantial notice of a third-party claim to a deposit account. *Compare* Northern Ins. Co. v. Traders Gate City Nat'l Bank, 239 Mo. App. 132, 186 S.W.2d 491 (1945) *with* Katz v. Belmont Nat'l Bank, 130 Ill. App. 3d 1094, 475 N.E.2d 543 (1984), *rev'd on other grounds*, 112 Ill. 2d 64, 491 N.E.2d 1157 (1986). *See generally* Nickles, *A Localized Treatise on Secured Transactions—Part 1: Scope of Article 9*, 34 Ark. L. Rev. 377, 419-23 (1980).

88. *See, e.g.*, Kane v. First Nat'l Bank, 56 F.2d 534 (5th Cir.), *cert. denied*, 287 U.S. 603 (1932); Strauss v. Tradesman's Nat'l Bank, 122 N.Y. 379, 25 N.E. 372 (1890); First Nat'l Bank v. Autrey, 9 Kan. App. 2d 96, 673 P.2d 448 (1983); Behring Int'l, Inc. v. Greater Houston Bank, 662 S.W.2d 642 (Tex. Ct. App. 1983).

enter into an agreement which allows the bank to unilaterally accelerate and trigger the borrower's obligation.[89] A broad definition of default, including cross default clauses and the like, is advisable.[90] In general, as long as the bank proceeds in good faith, the use of demand notes with acceleration clauses should allow the bank to adequately prepare for setoff.[91] However, certain setoffs against unmatured debts due banks are permitted under certain state statutes.[92]

For example, section 151 of the New York Debtor and Creditor Law gives a bank, as the debtor on the deposit account, the right to set off a matured or unmatured deposit liability against unmatured debts of its depositors where a depositor makes an assignment for the benefit of creditors, or a third party issues an execution (*i.e.*, takes steps to enforce an existing judgment against a depositor) or issues a warrant of attachment against a depositor.[93] Section 151 also gives the bank a right of setoff on the filing of a petition in bankruptcy, but the automatic stay of section 362(a)(7) of the Bankruptcy Code overrides this state law right. Thus, in New York, if there is an unmatured debt or deposit involved, the section 151 setoff may not work in bankruptcy. This is true because when the filing of a federal bankruptcy petition is the trigger for the section 151 right to setoff, the federal automatic stay forbids the setoff. Thus, any unmatured debt arguably could not benefit from section 151's acceleration provision since the right of setoff did not already exist at the time the bankruptcy petition was filed. In addition, there is authority to the effect that to satisfy section 553 of the Bankruptcy Code, both debts must be owing when the bankruptcy petition is filed.[94]

There is, however, an alternative view. Under the Bankruptcy Code a creditor may set off a debt owed the debtor against a "claim" against the debtor which arose before the commencement of the bankruptcy case.[95] As germane to this inquiry, "claim" means a right to payment, whether or not the right is matured or unmatured.[96] Thus, one could argue that at least

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89. Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 518 P.2d 734, 739 (Wash.), *cert. denied*, 419 U.S. 967 (1974).

90. *See* CLARK, *supra* note 27, ¶ 11.5[1], at 11-11.

91. *See* U.C.C. §§ 1-208, 1-201(19).

92. *See* ILL. CODE CIV. P. ch. 110, § 12-708 (1983); N.Y. DEBT. & CRED. LAW § 151 (McKinney Supp. 1989).

93. *See Industrial Comm'r v. Five Corners Tavern, Inc.*, 47 N.Y.2d 639, 395 N.E.2d 1005, 419 N.Y.S.2d 931 (1979); *Publishers Distrib. Corp. v. Independent News Co., Inc.*, 55 A.D.2d 571, 390 N.Y.S.2d 77 (1976).

94. This is Bankruptcy Code section 553's version of the maturity requirement. 11 U.S.C. § 553 (1982). *See In re* Hecht, 41 Bankr. 701 (S.D.N.Y. 1984); Clark, *Bank Exercise of Setoff: Avoiding the Pitfalls*, 98 BANKING L.J. 196, 197 (1981); Freeman, *Setoff Under the New Bankruptcy Code: The Effect on Bankers*, 97 BANKING L.J. 484, 492 (1980).

95. 11 U.S.C. § 553 (1982). A "claim against the debtor includes claims against property of the debtor." 11 U.S.C. § 102(2) (1982).

96. 11 U.S.C. § 101(4) (A) (1982) (defining "claim" to include unmatured debts of the

with respect to unmatured loan obligations owed to the bank by the debtor, such claims are recognized under the Bankruptcy Code and would suffice to invoke the protection afforded by section 553. Under the Bankruptcy Code a creditor especially in a state such as New York should be granted all the advantages of an unconsummated setoff even where the bank's claim was "unmatured" prior to bankruptcy. While this is the better construction of the Bankruptcy Code, no cases have been found where this argument has been suggested and there is authority to the contrary.[97]

3. *Automatic Stay in Bankruptcy*

No setoff may be made once a petition under the Bankruptcy Code has been filed by or against the bank's depositor. A bankruptcy filing triggers the automatic statutory stay against setoff imposed by section 362(a)(7) of the Bankruptcy Code. Although section 362(a)(7) enjoins exercise of the setoff right, considerable advantages accrue to the bank with an unconsummated setoff right under the bankruptcy law.

4. *Setoff Where Debt Is Otherwise Secured*

A minority of courts hold that a bank cannot apply deposits to pay down a depositor-debtor's matured indebtedness where that indebtedness is sufficiently secured by other collateral.[98] Under this minority view, the depository institution must first apply its security against the matured indebtedness which it secures.[99] While the authority on this point is divided,[100] the majority and better view is to allow setoff without requiring the bank to exhaust other dedicated collateral first.[101] The theory of the cases adopting

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debtor); 11 U.S.C. § 502(C) (1982) (providing for "claim" estimation). *See also In re* Manville, 57 Bankr. 680 (S.D.N.Y. 1986); *In re* A.H. Robins, 63 Bankr. 986 (E.D. Va. 1986).

97. *In re* Hecht, 41 Bankr. 701 (S.D.N.Y. 1984).

98. *See, e.g.*, Bank of Am. v. Daily, 152 Cal. App. 3d 767, ____, 199 Cal. Rptr. 557, 559 (1984); Gnarini v. Swiss Am. Bank, 162 Cal. 181, ____, 121 P. 726, 727 (1912); Farmers Nat'l Bank v. McFerran, 11 Ky. L. Rptr. 183 (1889); Forastiere v. Springfield Inst. of Sav., 303 Mass. 101, ____, 20 N.E.2d 950, 952 (1939) (right of setoff is implicitly limited by security agreement dedicating specific collateral as security for loan); Prudential Realty Co. v. Allen, 241 Mass. 227, ____, 135 N.E. 221, 222 (1922); Melson v. Bank of New Mexico, 65 N.M. 472, 332 P.2d 472 (1958); Zion's Sav. Bank & Trust Co. v. Rouse, 86 Utah 574, ____, 47 P.2d 617, 619 (1935). *See also* Nelson v. Bank of Am. Nat'l Trust & Sav. Ass'n, 76 Cal. App. 2d 501, ____, 173 P.2d 322, 325-26 (1946).

99. Olsen v. Valley Nat'l Bank, 91 Ill. App. 2d 365, 371, 234 N.E.2d 547, 550 (1968). *See also* Zollinger v. First Nat'l Bank, 126 Okla. 182, ____, 259 P. 141, 143-44 (1926); Seaboard Fin. Co. v. Shire, 117 Utah 546, ____, 218 P.2d 282, 286 (1950).

100. Olsen v. Valley Nat'l Bank, 91 Ill. App. 2d 365, 371, 234 N.E.2d 547, 550 (1968). *See also* Frank Briscoe Co. v. Suburban Trust Co., 100 N.J. Super. 431, ____, 242 A.2d 54, 56 (Super. Ct. App. Div. 1968) (authority cited therein).

101. *See, e.g.*, Jensen v. State Bank, 518 F.2d 1, 6 (8th Cir. 1975); United States *ex rel.* Crow Creek v. Sioux Tribe, 415 F. Supp 858, 868-69 (D.S.D. 1976); Duncan v. Coahoma Bank, 397 So. 2d 891, 893 (Miss. 1981); Keller v. Commercial Credit Co., 149 Or. 372, ____, 40 P.2d

this view is that the legislative intent of the U.C.C. allows creditors multiple remedies against a defaulting debtor. Thus, the majority view is consistent with the modern approach taken by the U.C.C. Under this view the bank need not proceed first against loan collateral before exercising its right of setoff.[102]

Setoff has been referred to as an inchoate right and an undisclosed security interest which unfairly advantages banks in particular. While it is true that setoff is a contingent interest in a deposit account which is not publicly noticed in accordance with either U.C.C. or lien notice filing systems, the suggestion that it unfairly advantages banks is overly simplistic. First, the right of setoff is available to all qualifying creditors and is widely known within the creditor communities, both finance and trade. Only the most unsophisticated creditor would be unaware that qualifying creditors may have setoff rights against certain debtor assets, including especially banks with respect to deposit accounts. Moreover, if one accepts classic microeconomic uncertainty theory, the right of setoff may be economically justified as an efficient option reducing the costs of loans by providing bank creditors with the assurance of reaching liquid assets in the form of deposit accounts. A final point, which may have greater validity, is that in performing the monitoring necessary to ensure that its setoff option is of value, a bank must maintain some vigilance over the debtor's behavior. This monitoring should provide an early warning to other creditors when the bank ceases to process checks in the ordinary course because of insecurity or default.

The post-bankruptcy benefits of unconsummated setoff may presuppose the existence of a pre-bankruptcy right of setoff.[103] If mutuality or maturity is lacking, then developing case law may establish that there was no right of setoff and therefore no benefit of unconsummated setoff.[104] For this reason,

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1018, 1021 (1935); Bee Jay's Truck Stop, Inc. v. Department of Revenue, 86 Ill. App. 3d 7, ____, 407 N.E.2d 755, 759-60 (1980); Olsen v. Valley Nat'l Bank, 91 Ill. App. 2d 365, ____, 234 N.E.2d 547, 550 (1968); Karner v. Willis, 10 Kan. App. 2d 432, ____, 700 P.2d 582, 584-85 (1985); Kress v. Central Trust Co., 246 App. Div. 76, 78, 283 N.Y.S. 467, 470, *aff'd* 153 Misc. 397, 275 N.Y.S. 14 (1935); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, ____, 518 P.2d 734, 739 (1974). *Cf.* Aiken v. Bank of Georgia, 101 Ga. App. 200, ____, 113 S.E.2d 405, 407 (1960) (bank does not lose right of setoff by reducing debt to judgment).

102. Even in jurisdictions following the minority rule, the setoff right probably can be enhanced by agreement so as to allow setoff notwithstanding the availability of other dedicated collateral. Frank Briscoe Co. v. Suburban Trust Co., 100 N.J. Super. 431, ____, 242 A.2d 54, 56 (Super. Ct. App. Div. 1968).

103. *In re* Hecht, 41 Bankr. 701, 703 (S.D.N.Y. 1984). *But see In re* Manville, 57 Bankr. 680 (S.D.N.Y. 1986).

104. With respect to maturity, as suggested above, the better view appears to be that unmatured claims against the debtor *are* encompassed within the Bankruptcy Code's right of setoff. The Code's language, however, would not appear to cover maturity problems arising because the debt owed *by the bank*—the deposit account—was not matured, *e.g.*, an unripened time account. Thus, under the Bankruptcy Code the right of setoff may include unmatured

or because they might be caught by a surprise bankruptcy, in some cases banks may conclude that the only safe-harbor position is a perfected security interest. Before discussing the preparation necessary to use a perfected security interest, a brief discussion of preparing to use debit is in order.

B. *Preparing to Use Debit*

Debit requires more planning than setoff. Debit is a contractually created right, not arising by operation of law. Yet precisely because debit is a contractually created right, the planning necessary to prepare for its use is limited only by the anticipated desires of the bank and its customer. As with any contract, the planning process must ensure that the anticipated contingencies are covered in the depository agreement. For example, if it is anticipated that setoff may not be available because of irreconcilable mutuality problems, the bank may want the right to use debit. To make use of our corporate family illustration once more, such a situation could arise where the sales subsidiary is the depositor and the manufacturing subsidiary is the borrower. Here setoff would not be available because of an irreconcilable lack of mutuality. The bank could still rely on the sales subsidiary's deposit account as a financing asset for the credit extended to the manufacturing subsidiary if the bank planned ahead and included the right to use debit in the depository agreement between the bank and the sales subsidiary. Careful consideration of the context in which a bank is likely to desire to use debit is necessary. However, the care required in planning to use debit pales by comparison to that necessary for using a perfected security interest, particularly one not involving an indispensable instrument.

C. *Preparing to Use Perfected Security Interest*

1. *The Creation and Perfection of Security Interests*

Creating a security interest requires only the manifestation of an intent to do so, ordinary consideration and sufficient rights in the collateral on the part of the debtor.[105] A security interest may be created orally unless an applicable statute, such as the U.C.C. statute of frauds, requires a writing.[106] An example of the creation of a security interest in writing would be the signing of a real estate mortgage or the signing of an agreement pledging stock to a bank. An example of a security interest created orally would be the delivery of a ring to a pawnbroker as security for a loan.[107]

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claims of the creditor (herein a bank) against the debtor but not unmatured claims of the debtor against the creditor bank.

105. *See* United States v. Ed Lusk Constr. Co., 504 F.2d 328, 331 (10th Cir. 1974); 79 C.J.S. *Secured Transactions* § 9 (1974). *Cf.* 1 GILMORE, *supra* note 4, § 11.1.

106. *See* U.C.C. § 9-203.

107. While no writing is required to create such a common law security interest, the pledgee, such as a pawnbroker, may have certain statutorily imposed record keeping require-

As between the grantor of a security interest, usually the debtor in the transaction, and the secured party, the contractual agreement is all which is required to create a security interest in the grantor's property. However, absent the further step of perfection, creation alone leaves the security interest vulnerable to the rights of a variety of other creditors.

2. *Perfection — The Requisite for Priority over Other Creditors, Especially the Bankruptcy Trustee and the IRS*

If a security interest is not perfected,[108] its holder's rights will be inferior to the rights of, among others, holders of other security interests which are perfected first,[109] executing holders of court judgments against the debtor,[110] the debtor's estate in bankruptcy, [111] and the IRS with an attaching tax lien.[112] Moreover, under most pre-Code law a security interest which was first in time and of which subsequent creditors have or ought to have knowledge, has priority.[113]

Under the Bankruptcy Code, the estate in bankruptcy may be represented either by the debtor itself, as debtor in possession (hereinafter DIP), or by an appointed bankruptcy trustee (hereinafter Trustee).[114] Section 544 of the Bankruptcy Code gives the estate an automatic judicial lien on all property of the bankrupt.[115] With some exceptions, this lien represents an interest superior to that of all other creditors, except security interests which are validly created *and perfected* before the bankruptcy case is commenced.[116] In other words, vis-a-vis the estate and its trustee (or the DIP), an unperfected security interest is the same as no security interest. Thus the perfection of a security interest under state law is the *sine qua non* of success against the bankruptcy trustee.

Similarly, under the Internal Revenue Code, a state-created perfected security interest is generally recognized and given priority over the attaching

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ments. *See, e.g.*, N.Y. GEN. BUS. LAW § 43 (Consol. 1982).

108. The term "perfected" is derived from bankruptcy law and apparently does not appear in pre-U.C.C. security statutes. 1 GILMORE, *supra* note 4, at 435.

109. U.C.C. § 9-312(5).

110. U.C.C. § 9-301(1)(b).

111. U.C.C. § 9-301(3).

112. *See* part VIII, *infra*.

113. *E.g.*, Edge v. Smith, 284 P.2d 711 (Okla. 1955) (cited in 2 GILMORE, *supra* note 4, § 34.2, at 896, n.1).

114. 11 U.S.C. §§ 1101(1), 1107(a) (1982). Since for most purposes under the Code, the DIP has the powers of the trustee, unless and until displaced by the appointment of a trustee, the term trustee will be used herein to refer to both.

115. 11 U.S.C. § 544 (1982).

116. The major exception is contained in 11 U.S.C. § 546(b) (1982), which subjects the trustee's avoiding powers to general laws which permit grace periods prior to the customary perfection. Typical of such provisions would be U.C.C. § 9-301(2) which allows retroactive effectiveness against certain creditors for purchase money security interests perfected within ten days after the debtor receives possession of the collateral.

tax lien. Conversely, those security interests which are not perfected are not recognized. Thus in order to be protected against a federal tax lien, a bank would have to have a security interest, the perfection of which was recognized under state law.

Perfection of a security interest in personal property is most frequently achieved in one of two ways: either through physical possession of the collateral or through some kind of public filing. Possession is generally deemed sufficient because it deprives the pledgor, usually the debtor, of control over the asset and creates "notice to the world" that someone other than the pledgor has an interest in the property.[117] In the classic case of the oral pledge to the pawnbroker, the broker's possession of the ring perfects the security interest.[118] In the case of the mortgage, perfection is achieved by recording the mortgage in the land records office. In the case of a pledge of stock certificates, certificates of deposit or other instruments, physical possession is necessary.[119] In the case of pledges of accounts receivable, inventory and most general intangibles, generally filings are required to achieve perfection.[120]

3. *Perfection of Security Interests in Most Personal Property Is Achievable Under Article 9 of the U.C.C.*

Article 9 of the U.C.C., in force in one form or another in all states except Louisiana, governs the creation and perfection of security interests in most forms of personal property. Article 9 normally requires a written security agreement.[121] The U.C.C. provides that perfection is achieved through possession of the collateral, as in the case of investment securities,[122] or by filing a U.C.C.-1, a standardized financing statement providing public notice, as in the case of security interests in accounts receivable.[123] In the case of chattel paper and documents of title, perfection is achieved through possession or filing or both.[124]

4. *Perfection of Security Interests in Bank Deposit Accounts (Not Incorporated into an Indispensable Instrument) Cannot Be Achieved Under Article 9 of the U.C.C. (except in California and Hawaii)*[125]

Section 9-104(1) of the U.C.C. declares that Article 9 is not applicable

117. *See* Coogan, *Article 9—An Agenda for the Next Decade*, 87 YALE L.J. 1012, 1014-15 (1978) [hereinafter Coogan].

118. U.C.C. § 9-305.

119. U.C.C. § 9-304.

120. U.C.C. § 9-302.

121. U.C.C. § 9-203.

122. U.C.C. § 9-304.

123. *Id.*

124. *Id.*

125. A proposal to include secondary interests, such as security interest, in deposit ac-

"to a transfer of [a security] interest in any deposit account." The purpose of the exclusion was to relegate such transfers to the existing common law and to declare that it was not contrary to public policy for there to be a perfected security interest in a bank account.

This exclusion did not appear in the 1953 text of the U.C.C. draft. It was adopted by the Article 9 Subcommittee at its annual meeting in the fall of 1956.[126] The exclusion does not seem to have been the subject of great debate; it merely reflected the contemporaneous thought that such transfers were beyond the scope of a statute devoted to commercial financing.[127]

Official Comment No. 7 to U.C.C. section 9-104 states that security interests in deposit accounts are excluded from the ambit of the U.C.C. because "[s]uch transactions [*inter alia*] are adequately covered by existing law." Consistent with this comment, cases discussing this exclusion have uniformly held that security interests in savings accounts cannot be perfected under Article 9.[128] At least one case has held that the section 9-104(1) exclusion applies to an assignment of a checking account so that no security interest under Article 9 can be created by an assignment of a checking account.[129]

California and Hawaii are the exceptions. Their versions of the U.C.C. permit perfection by filing.[130]

The fact that the U.C.C. is not applicable to security interests in bank deposits does *not* mean that there are no lawful ways to create such interests.[131] It simply means that the applicable law must be taken from another source. That source is the common law which was intended to continue to apply to excluded transactions.[132] The U.C.C. does not preempt the common

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counts within the structure of Article 9 has been put forth in a detailed and thorough article. *See* Zubrow, *supra* note 9, at 932.

126. These changes were included in an August 25, 1955 draft of Article 9 circulated by Peter F. Coogan. *See* VI WILLARD, *supra* note 4, at doc. 48.

127. 1 GILMORE, *supra* note 4, § 10.7, at 316.

128. *E.g.*, *In re* Amoco Prod., Inc., 17 Bankr. 758, 760-62 (W.D. Mo. 1982); Walton v. Piqua State Bank, 204 Kan. 741, ____, 466 P.2d 316, 326 (1970); Iser Elec. Co. v. Ingran Constr. Co., 48 Ill. App. 3d 110, ____, 362 N.E.2d 771, 779 (1977); Rowland v. American Fed. Sav. & Loan Ass'n, 523 S.W.2d 207, ____ (Tenn. App. 1975).

129. Willow City Elevator v. Vogel, Vogel, Brantner & Kelly, 268 N.W.2d 762, 766-67 (N.D. 1978) (checking account as chose in action assignable under the common law, but check or draft on account does not act as an assignment until accepted or finally paid under U.C.C. § 3-409).

130. *See* CAL. COM. CODE § 9302(1)(g)(West Supp. 1988); HAW. REV. STAT. §§ 490-9-104, 490-9-302(1)(h)(1985).

131. The U.C.C. "is not a comprehensive codification of commercial law." J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 2, at 6 (2d ed. 1980).

132. 1 GILMORE, *supra* note 4, § 10.7, at 316. *See also* Peoples Nat'l Bank v. United States, 777 F.2d 459, 461 (9th Cir. 1985); Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548, 561-63 (2d Cir. 1976); United States v. Sterling Nat'l Bank & Trust Co., 360 F. Supp. 917, 924 (S.D.N.Y. 1973), *modified on other grounds*, 494 F.2d 919 (2d Cir. 1974); Walton v. Piqua State Bank, 204 Kan. 741, ____, 466 P.2d 316, 327 (1970); Gillman v. Chase Manhattan Bank, 73

law with respect to such transactions.[133]

Nevertheless, it is clear that a security interest in a deposit account incorporated into a bank-issued instrument, such as a certificate of deposit or a certified or official bank check, which converts the deposit liability of the bank into an indispensable instrument, can be perfected under the U.C.C. by possession. This is the same method available under the common law with respect to instruments not covered by the U.C.C.[134]

5. *Use of Bank-Issued Instruments*

As suggested by the *Restatement of Security* and *Wells Fargo*,[135] one way to avoid the problem of the lack of an "indispensable instrument" is to create one—and better yet, create one which is cognizable under Article 9. Such a security interest unquestionably can be perfected by possession.[136]

a. Use of Certificates of Deposit. Banks have inherent power to issue certificates of deposit.[137] "In the absence of statutory or constitutional prohibitions, banks may issue certificates of deposit payable either on demand or time."[138] This power of banks to issue demand certificates of deposit is illustrated by *Barnes v. Ontario Bank.*[139] In that case the court wrote: "There is no pretense that these certificates of deposit, payable as they were, on demand, fall within any of the restraints imposed by law upon the banking institutions of the state. They were therefore valid instruments, so far as any questions of corporate power to issue them is concerned."[140]

The U.C.C. section 9-104 exclusion of deposit account from the scope of Article 9 does not apply to certificates of deposit by virtue of section 9-105(e), which defines deposit accounts as: "demand, time, savings, passbook or like account maintained with a bank, savings and loan association, credit union or like organization, other than an account evidenced by a certificate of deposit."[141] Thus, Article 9 of the U.C.C. governs the use of certificates of

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N.Y.2d 1, 534 N.E.2d 824, 537 N.Y.S.2d 787 (1988); Duncan Box & Lumber Co. v. Applied Energies, Inc., 165 W. Va. 473, ____, 270 S.E.2d 140, 143 (1980); Wightman v. American Bank, 591 P.2d 903, 906 (Wyo. 1979); Roosevelt Fed. Sav. & Loan Ass'n v. First Nat'l Bank, 614 S.W.2d 489 (Mo. App. 1981).

133. U.C.C. § 1-103. *See also* Wightman v. American Nat'l Bank, 591 P.2d 903, 906 (Wyo. 1979) (pledge of certificates of deposit).

134. *See generally* McLaughlin, *supra* note 6, at 49-52.

135. Miller v. Wells Fargo Int'l Corp., 540 F.2d 548, 562-63 (2d Cir. 1976).

136. For example, the depositor could draw a check upon his account which would be certified, charged to the depositor's account and retained by the bank as security for any indebtedness. *See* Ingber v. Tradesman's Nat'l Bank, 230 Pa. 511, ____, 79 A. 751, 752 (1911).

137. 9 C.J.S. *Banks and Banking* § 312 (1938). *See also* Merchants' Nat'l Bank v. State Bank, 77 U.S. 1008 (1870).

138. 9 C.J.S. *Banks and Banking* § 312, at 639 (1938).

139. Barnes v. Ontario Bank, 19 N.Y. 152, 156 (1859).

140. *Id.* at 156.

141. U.C.C. § 9-105(e) (emphasis added).

deposit as security.[142]

A certificate of deposit is defined as a negotiable instrument which is "an acknowledgment by a bank of a receipt of money with an engagement to repay it."[143] Section 9-304 states that a security interest in instruments "can be perfected only by the secured party's taking possession."[144] Thus, a bank which takes possession of a certificate of deposit would acquire a perfected security interest in the instrument under the U.C.C. (assuming, of course, that the other requirements for attachment of a security interest are otherwise satisfied).[145]

For the purposes of becoming a secured party with respect to its own debt instrument, several cases establish that a bank can acquire a perfected security interest in its own certificates of deposit.[146] These cases also clearly establish that a bank generally must take possession of the certificate to perfect its security interest.[147]

Thus, both as a matter of statutory analysis and as a matter of case law, a bank can perfect a security interest in certificates of deposit under Article

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142. Rankin v. First Nat'l Bank, 416 So. 2d 738, 740 (Ala. 1982).

143. U.C.C. §§ 3-104(1), 3-104(2)(c). U.C.C. § 3-104(3) states that a certificate of deposit may be negotiable or non-negotiable. The requirements for negotiability are set forth in U.C.C. § 3-104(1): The writing must "(a) be signed by the maker or drawer; (b) contain an unconditional promise or order to pay given by the maker or drawer except as authorized by this Article; (c) be payable on demand or at a definite time; and (d) be payable to order or bearer."

144. The U.C.C. section 9-105 definition of "instrument" is a negotiable instrument as defined in U.C.C. section 3-104.

145. *See* U.C.C. § 9-203. In summary, the requirements for possessory security interests are (1) a security agreement; (2) the extension of value; and (3) debtor who has rights in the collateral.

146. Continental Bankers Life Ins. Co. v. Bank of Alamo, 578 S.W.2d 625, 630 (Tenn. 1979) (the court noted that the "proper methods of perfecting would be to take the certificates of deposit as a pledge by possession"); Citizens Nat'l Bank v. Bornstein, 374 So. 2d 6 (Fla. 1979) (rejecting the bank's setoff claim due to lack of mutuality—a third party pledgee had an interest in the deposit through possession of the certificates of deposit—the court held that the assignee's security interest in the certificates of deposit was perfected when it took possession of the certificates of deposit and was superior to the issuing bank's unperfected interest); Montavan v. Alamo Nat'l Bank, 554 S.W.2d 787, 791 (Tex. Civ. App. 1977)(the bank's security interest was perfected when the certificates were delivered to the bank). But a caveat: delivered with the certificate of deposit in *Montavan* were two writings: a "Consent to Pledge" and "Security Agreement—Pledge." The decision is not entirely clear as to whether these instruments were necessary to create and perfect a security interest in the certificates of deposit. The court quoted U.C.C. section 9-304(a), which provides for perfection in instruments by possession, but the court also stated that the two writings should be "read and construed together" to find a valid security interest. Thus, in Texas at least it might be prudent to have delivery of the certificate of deposit accompanied by a writing. *Cf.* First Nat'l Bank v. Lone Star Life Ins. Co., 524 S.W.2d 525, 529 (Tex. 1975) (only means of perfecting security interest in certificate of deposit is by secured party's taking possession); Wightman v. American Nat'l Bank, 591 P.2d 903, 903 (Wyo. 1980)(the bank had a perfected security interest in the certificates of deposit when it obtained possession in accordance with the "Collateral Agreement," evincing the parties' intent to create a security interest in the certificate of deposit by delivery thereof).

147. *See* note 146 *supra*.

9 by taking possession. The U.C.C. and case law recognize no distinction between possession of certificates of deposit as security by the issuing bank and possession by a non-issuing bank. The problems associated with the assignment and pledge of deposits to the bank obligated on the underlying chose in action do not exist where the bank issues certificates of deposit which are thereafter possessed by the bank as collateral. Such certificates are the debtor's property. The bank can obtain a lien on that property and perfect it through possession.[148]

Given that the certificate of deposit is the only corporal representation of the underlying chose in action, it is significant that perfection through possession allows the holder to control this intangible, for the most part. Control and possession are virtually synonymous. In addition, the problem of monitoring this collateral is substantially eliminated since, as illustrated by *Continental Bankers Life Insurance Co. v. Bank of Alamo*,[149] any disposition of this collateral not reflected on the face of the instrument is subordinated under the common law to the possessory interest.

b. Federal Regulatory Problems with Use of Certificates of Deposit. Certificates of deposit are typically interest-bearing time deposits. Interest on these deposits is governed by various federal regulations which, among other things, prescribe ceilings on rates of interest, impose minimum maturities (currently fourteen days), and require reserves to be deposited with a federal reserve bank. If the deposit collateral arrangements the bank wishes to use can be implemented as a business matter with a conventional, interest-bearing fourteen-day or longer certificate of deposit, then there is no need for further analysis.[150]

c. Use of Certified or Official Bank Checks. The payment-of-interest problems discussed above may be avoided by use of non-interest-bearing instruments issued by the bank.[151] The U.C.C. would govern the perfection of a security interest in such instruments.

A security interest in "instruments," like a security interest in certificates of deposit, can be perfected only by possession under U.C.C. section 9-

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148. Under New York law the use of a time instrument may limit a bank's right of setoff until the day after the instrument matures. *In re* Hecht, 41 Bankr. 701, 705 (S.D.N.Y. 1984). *See also* U.C.C. § 3-122(1)(a) (no cause of action on a mature certificate of deposit until the day after maturity—"action" includes setoff); Marine Midland Bank v. Graybar Elec. Co., 41 N.Y.2d 703, 363 N.E.2d 1139, 395 N.Y.S.2d 403 (1977).

149. Continental Bankers Life Ins. Co. v. Bank of Alamo, 578 S.W.2d 625, 630 (Tenn. 1979).

150. However, if the bank does not want to pay interest or if the maturity is to be shorter than fourteen days, can the certificates of deposit be used? Can a bank lawfully issue a shorter-than-fourteen-day certificate of deposit (or even a demand certificate) of deposit which bears no interest? The answer to these intriguing questions will be left to others.

151. While this would make borrowing more costly for the customer, compensating adjustments could be made elsewhere to maintain the customer's net costs. Perhaps the loan interest charges could be reduced.

304. U.C.C. section 9-105(1)(i) defines "instrument" as "a negotiable instrument" within the meaning of section 3-104. That section explicitly includes a "check" as a type of negotiable instrument.[152] The conclusion is therefore obvious that an Article 9 security interest can be perfected in a check by taking possession of it.

However, since a check is not an assignment of funds,[153] and the payor-drawee bank owes virtually no obligation to the payee or other holder of an uncertified check, perfection of a security interest in a check itself is of little value except possibly as against the maker-drawer. To cause a check to transfer an interest in the underlying chose in action, it is necessary to certify the check. Certification is the bank's signed undertaking to pay the underlying chose in action drawn by the check to the payee.[154] It represents an acknowledgment by the bank owing the chose in action that the bank has obligated itself to pay that debt to the payee on (or bearer of) the certified check. This is usually accomplished either through a charge against the drawer's account or through a "freeze" of the amount of the check. Whatever the mechanics, through the combination of certification of a check and perfection by possession, a bank can acquire a perfected security interest in its depositor's account.

As with certificates of deposit or corporate bonds, there is no circularity problem. A bank, in possession of a certified check made payable to its order or bearer, has possession of property of its debtor and may hold that property as collateral for its loan.

The principles in the cases relating to a bank's ability to perfect a security interest in certificates of deposit should apply to certified or cashier's checks.[155] Thus, a bank should be able to perfect a security interest in a customer's check if it has possession of a certified or a cashier's check it has issued. In both cases the check should be made out to (a) the debtor-drawer and endorsed in blank or to the order of the bank, or (b) the bank, as pledgee.

The law in most jurisdictions is to the effect that holder certification of

152. U.C.C. § 3-104(2)(b) defines a check as "a draft drawn on a bank and payable on demand."

153. U.C.C. § 3-409.

154. U.C.C. §§ 3-410(1), 3-411(1), 3-413(1).

155. A cashier's check is a check drawn by the bank on itself. It should be considered a non-interest-bearing version of a certificate of deposit. *See* Kaufman v. Chase Manhattan Bank, 370 F. Supp. 276, 279 (S.D.N.Y. 1974) (such check is similar to a certified check since both circulate as primary obligations of the issuing bank and as substitutes for the money represented); Gillespie v. Riley Management Corp., 59 Ill. 2d 211, 319 N.E.2d 753, 756 (1974); Ingber v. Tradesman's Nat'l Bank, 203 Pa. 511, 79 A. 751 (1911) (the terms "bank check" and "cashier's check" appear to be interchangeable); Dziurak v. Chase Manhattan Bank, 58 A.D.2d 103, 104, 196 N.Y.S.2d 414, 415, *aff'd* 44 N.Y.2d 776, 377 N.E.2d 474, 406 N.Y.S.2d 30 (1978) (a bank or cashier's check is a promise by the bank to draw the amount of the check from its own resources and to pay the check upon demand).

a check discharges the drawer thereof from liability on the instrument and directly obligates the bank to the holder of the instrument.[156] While this rule suggests that where the drawer procures certification the drawer is not discharged, this appears to have no impact on the bank's ability to use such a check as collateral.

For example, in *Standard Factors Corp. v. Manufacturers Trust Co.*,[157] the plaintiff obtained a warrant of attachment upon the property of a bank customer who maintained a checking account at the defendant bank. Sometime before the warrant was served the bank customer drew a certified check payable to his own order and the bank debited his account accordingly. When the warrant was served the bank declined to honor it, maintaining that the funds no longer constituted a part of the checking account and were not subject to payment upon an open account. The court agreed that "the obligation of the bank to a depositor is upon the check, and not upon an open account, and hence the only manner in which attachment and levy could be effectively made . . . was to levy upon the instrument itself." The court observed that:

> upon the certification of the check, *eo instante*, the sum appropriated from the credit of the drawer thereupon stood as a sum to the credit of the certified check; the relationship of bank and depositor assumed a different form; the bank's obligation to its depositor was transmogrified [sic] from one on open account to an obligation upon the check, no matter at whose instance the certification was procured.[158]

This decision was followed in *Feingold v. Ornoff*[159] and favorably cited in *Jones v. Bonaventure*.[160]

As illustrated by this New York case law, it would appear that if bankruptcy occurred after a certified or bank check was issued, the chose in action would have been effectively pledged and would have been considered property of the debtor held pursuant to a perfected security interest. This asset would still be property of the estate unless the bank had actually foreclosed on the check and extinguished the chose in action prior to bankruptcy.[161] In other words, the check would remain a valid pledge of the

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156. U.C.C. § 3-411(1).

157. Standard Factors Corp. v. Manufacturers Trust Co., 182 Misc. 701, 703, 50 N.Y.S.2d 10, 12 (Sup. Ct. 1944), *aff'd*, 269 A.D. 658, 53 N.Y.S.2d 461 (1945).

158. *Id.* at 705, 50 N.Y.S.2d at 14-15.

159. Feingold v. Ornoff, 57 N.Y.S.2d 68, 70 (Sup. Ct. 1945).

160. Jones v. Bonaventure, 32 Misc. 2d 451, 453, 205 N.Y.S.2d 245, 247 (Sup. Ct. 1960).

161. 11 U.S.C. §§ 541, 542 (1983). *See also* United States v. Whiting Pools, Inc., 462 U.S. 198, 231 (1983)(holding that Section 542(a) required the I.R.S. to "turnover" collateral in its possession following foreclosure on its tax lien where the debtor still had a right of redemption).

This analysis is consistent with the fact that under state law the certification by the drawer did not effect a discharge. *See* U.C.C. § 3-802. In other words the underlying ownership of the chose in action has not been transferred and the debtor still has a contingent interest in the account.

chose in action duly perfected under state law by possession, but it would not eliminate all potential involvement of the asset in a bankruptcy proceeding.

If a bank's interest in a certified check were considered a perfected security interest for bankruptcy purposes, it probably would be concluded that a debtor retained a property interest in the underlying chose in action even after a default. Such a contingent interest could be considered either a right of redemption or a right to any value in excess of the security interest. On this view the bankruptcy estate might be entitled to use this collateral with the permission of the court as "cash collateral," if the estate provided the bank with "adequate protection."[162]

Such a determination might be disadvantageous to a bank. First, there are the much discussed and litigated questions as to whether and under what conditions "adequate protection" is fully compensatory.[163] But perhaps of even greater consequence, if a bank were deemed partially or fully secured by the substituted property, it might lose or compromise the considerable advantage it could achieve if its interests were considered an unconsummated setoff.[164] In other words, there is some risk that a bank with a perfected security interest in an instrument might end up in a position worse than that of a bank with an unconsummated setoff.[165] The bank creditor might not only be subject to preference attacks, but might also have to suffer the use of its cash collateral and the vagaries of "adequate protection."

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162. 11 U.S.C. section 363(a)(1982) defines "cash collateral" and includes "cash equivalents" such as certified checks. In this context a court might, for example, require the debtor to grant the bank creditor a lien on other non-cash assets in lieu of the bank's lien on the certified checks. Obviously this would not always be an entirely satisfactory alternative for the bank. Thus, the *Whiting Pools* rule (discussed *infra* in part V) would appear to encourage banks to foreclose on and extinguish the chose in action prior to bankruptcy. Given that the creation of the security interest is considered a transfer under the Bankruptcy Code's preference provisions, it could be argued that extinguishing the chose in action did not constitute another transfer and therefore did not trigger the preference provisions anew.

163. *See* United Sav. Ass'n v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 370-71 (1988); *In re* All-Way Serv., Inc., 73 Bankr. 556 (E.D. Wis. 1987); Baird & Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. Chi. L. Rev. 97 (1984); Schorer, *The Right of the Undersecured Creditor to Postpetition Interest in Bankruptcy on the Value of Its Collateral: Implications of Recent Cases*, 21 U.C.C. L.J. 61 (1988); Comment, *Compensation for Time Value as Part of Adequate Protection During the Automatic Stay in Bankruptcy*, 50 U. Chi. L. Rev. 305 (1983).

164. *See* Zubrow, *supra* note 9, at 995.

165. Some scholars, while acknowledging that Congress intended unconsummated setoff to be preferred in bankruptcy, argue that such advantageous treatment frustrates the bankruptcy goal of treating similar creditors similarly. Zubrow, *supra* note 9, at 994.

6. *The* Duncan Box *Special Reserve Account: Pledge Without an Instrument*

The most underutilized common law loan loss minimization device is the perfected security interest. Perfected security interests have not been utilized much because counsel do not know how to reliably create and perfect such security interests. This section will provide guidance in creating and perfecting a common law security interest in a deposit account.

The case in which the non-instrumental perfected security interest doctrine coalesced is *Duncan Box & Lumber Co. v. Applied Energies, Inc.*[166] *Duncan Box* held that a deposit account, as a chose in action, could be pledged without an indispensable instrument or its functional equivalent and that the resulting security interest was perfectible through exclusive control of the deposit account by the bank.[167] In addition, the bank in *Duncan Box* had not issued any writing which could mislead other potential creditors. Apparently the only writing available which evidenced the account was the deposit agreement which assigned and pledged the deposit account.[168]

Duncan Box drew upon the modern development of intangible property law and the derivative understanding that choses in action are fully capable of being assigned and pledged.[169] The court in *Duncan Box* developed its modern view of common law pledge based on prior cases which had reached various conclusions concerning the ability to assign and then pledge deposit accounts.[170]

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166. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140 (W. Va. 1980).

167. *Id.* at 145-46. *Compare* Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548, 561-63 (2d Cir. 1976) (considering whether a telex key could be an indispensable instrument necessary to effect a pledge of a deposit account under New York law).

168. No mention is made in *Duncan Box* of any periodic statements of account or the like. As discussed *infra*, any such statement issued by the bank should prominently note the bank's security interest in the deposit account.

169. *See generally* GILMORE, *supra* note 4, §§ 1.2, 1.6, 7.2, 7.5; Bordwell, *The Alienability of Non-Possessory Interests*, 19 N.C.L. REV. 279 (1941); Bailey, *Assignments of Debts in England from the Twelfth to the Twentieth Century*, 47 LAW Q. REV. 516 (1931).

One of the best short histories of the development of the law of assignment and choses in action remains Professor Corbin's. *See* A. CORBIN, CORBIN ON CONTRACTS, § 856 at 403-09 (1951). For somewhat more extensive treatments see 7 HOLDSWORTH, HISTORY OF ENGLISH LAW: THE COMMON LAW AND ITS RIVALS Chap. 2, § 3 at 515 (1922); Holdsworth, *The History of the Treatment of Choses in Action by the Common Law*, 33 HARV. L. REV. 997 (1920); and Glenn, *The Assignment of Choses in Action; Right of Bona Fide Purchaser*, 20 VA. L. REV. 621 (1934).

170. United States v. Harris, 249 F. Supp. 221, 222-23 (W.D. La. 1966) (government claimed a federal tax lien in two checking accounts "pledged" as loan collateral where "collateral pledge agreement" provided that, should any indebtedness secured by the agreement become due or declared due, in accordance with the terms thereof any and all funds deposited to the credit of either or both of the taxpayers but in the possession of the bank could be applied in reduction of the secured debt; all of the conditions for pledge had been established: (1) the identity of the lienor, (2) the property subject to the lien, and (3) the amount of the lien; bank "lien" was "choate" or "complete" in the sense that there was nothing more to be done to have

The case on which the court relied in *Duncan Box* was *Miller v. Wells Fargo Bank International Corp.*[171] In that case the Second Circuit Court of Appeals found that the New York U.C.C. excluded security interests in deposit accounts as original collateral and held that the common law controlled.[172] The court also noted that under New York law choses in action were fully assignable.[173] The court went on to note that to effect an assignment, delivery of the property was not necessary because any act or words are sufficient which "show an intention of transferring the chose in action to the assignee, when the assignor is divested of all control and right to the chose in action and the assignee is entitled to control it and receive its fruits."[174] The court concluded that there was no effective assignment of an interest in the deposit account because the transaction had not been perfected, vesting the assignee bank with an irrevocable present right in the chose in action and divesting the assignor of all control.[175]

The court in *Miller* went on to consider as an alternative theory whether there had been a perfected pledge of the deposit account. The court held that there was no valid pledge because there was no functional equivalent of an indispensable instrument.[176] The court construed the *Restatement of Security* and New York law as requiring delivery of such an indispensable instrument and rejected the argument that the bank's telex key number, which had not been disclosed to the depositor, was a functional equivalent. In rejecting this argument the court stressed two necessary features of common law pledge: (1) control over the collateral and (2) notice to other potential creditors.[177] The telex code did not demonstrably satisfy

priority over federal tax lien; not necessary to reach issue of bank right of setoff); Anderson v. Pacific Bank, 112 Cal. 598, ____, 44 P. 1063, 1064 (1896)(court concluded that the deposit agreement, a criminal bail bond, created a special deposit whereby the pledgee bank did not obtain title to or general use of the deposited funds; bank was held to have wrongfully commingled and *perhaps* used these funds; interest allowed from the date of demand for return of money pursuant to the special deposit agreement); Walton v. Piqua State Bank, 204 Kan. 741, ____, 466 P.2d 316, 329 (1970)(incorporeal personal property could be pledged either by actual delivery of the document of title, if any, or by written transfer by assignment, placing the chose in action within the power of the pledgee to be available to satisfy the loan obligation it secured; court concluded that the bank, having neither written assignment of the chose in action nor possession of the savings account passbook—when both together are preferable in connection with hypothecation of savings accounts—did *not* have a "lien" by pledge); Madsen v. Prudential Fed. Sav. & Loan Ass'n, 558 P.2d 1337, 1340 (Utah 1977)(court held that certain payments were pledged as security and that, at least in the absense of a contractual provision to the contrary, pledgor was entitled to profits from use of pledged property during period of pledge).

171. Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548 (2d Cir. 1976).
172. *Id.* at 557 n.12.
173. *Id.* at 557.
174. *Id.*
175. *Id.* at 558.
176. *Id.* at 563.
177. *Id.*

these requirements.[178]

The essential elements of pledges were identified as: (1) the existence of a debt or obligation, (2) a transfer of the property to the pledgee, and (3) such property to be held as security or used to ensure performance.[179]

With a quite solid foundation,[180] the court in *Duncan Box* proceeded to coalesce the developing common law with respect to incorporeal perfected security interests by pledge. The court broke new ground by most clearly articulating the conditions under which a bank could create and perfect by common law pledge a security interest in a deposit account without an "indispensable instrument."[181]

Although the precise structure of the financing arrangement is not clear, it appears from the facts of *Duncan Box* that the deal was structured in three layers. On the first layer the bank agreed to finance a deed of trust of land for ultimate resale to mobile home dwellers.[182] A second layer of this transaction, intended to finance the resale of lots to the individual purchasers, required the assignment to the bank of the promissory notes which were the proceeds of the lot sales.[183] Some of these notes were purchased by and assigned to the bank without recourse. This arrangement resulted in a "payable" due the land developer, presumably in the form of a credit to an account with the bank. The third layer of this financing agreement gave the bank the right to deposit twenty-five percent of the amount "otherwise payable" to the developer in connection with the assignments of the note and

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178. Significantly, the court in *Miller* treated the question of effective assignment and common law as discrete questions. There is long standing common law authority in New York, not discussed by the Second Circuit, for the proposition that an assignment of a chose in action as a security for a loan is "in the nature of a pledge." Fairbanks v. Sargent, 22 N.Y. 1039, 1041 (1889).

179. Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d at 561.

180. *Anderson* is cited merely as an illustration of the analytically inadequate treatment of deposit accounts as a tangible object—money. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140, 145 n.10 (W. Va. 1980). In *Duncan Box* the court also cited *Harris*, and *Madsen* for the same proposition. *Id. Harris* is actually stronger precedent than even the court in *Duncan Box* acknowledged. *See* United States v. Harris, 249 F. Supp. 221 (W.D. La. 1966).

The court in *Harris* conceived of deposit accounts as "credits" and upheld the assignment and pledge of such credits. The court in *Duncan Box* relied upon *Walton. Walton* is primarily concerned with the requirements for using a savings account passbook as collateral. Walton v. Piqua State Bank, 204 Kan. 741, 466 P.2d 316 (1970). Yet *Walton* contains dicta to the effect that a valid pledge of incorporeal personal property could be created by written transfer by assignment, placing the chose in action within the power of the pledgee as collateral. *Id.* at ——, 466 P.2d at 328. Other than *Wells Fargo*, the remaining cases on which the court in *Duncan Box* relied were for the most part local authority establishing the principles of pledge, distinguishing it from mortgage, and applying the principles of pledge to intangible like corporate stock. *See* Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d at 143-46.

181. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d at 145-46.

182. *Id.* at 141.

183. *Id.*

deed of trust into a "reserve account." Under the reserve account agreement, the developer had no interest in this account until it paid (within fourteen days of an annual request) an amount in excess of fifteen percent of the total unpaid balance on all paper purchased by the bank. The funds deposited into the reserve account were not otherwise subject to withdrawal by the developer but could be used by the bank in its discretion to satisfy any loss it might suffer as a result of a breach by the developer.[184]

On the basis of this financing arrangement, particularly with respect to the "reserve account," the court concluded that the deposit agreement manifested "an unequivocal intention to permit the Bank to control the reserve account so that it might retain, without further consent or action on the part of the [developer] the amount due . . . ."[185] The court added that "access to the reserve account was available only to the Bank."[186]

Thereafter, the developer terminated its business. Two creditors of the developer, through separate proceedings, obtained judgments against the developer and attached the reserve account. The bank argued that since the account balance did not exceed 25% of the amount then owed to it by the developer, the developer had no interest in the account.[187]

The West Virginia court first rejected the creditor's contention that the bank's failure to file a financing statement pursuant to U.C.C. section 9-302(1) was germane to its determination whether the bank or the attaching judgment creditor had priority.[188] The court concluded, after a proper analy-

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184. The material provision of the agreement creating this account stated:

> [The Bank] shall have the right to deposit in a reserve account twenty-five percent (25%) of the amount otherwise payable to Debtor in connection with the assignments of the note and deed of trust to [the Bank]. The reserve account may be used by [the Bank] in [its] sole discretion to pay or satisfy any loss, cost, damages or expenses [it] might suffer or incur resulting from such a breach by Debtor. [The Bank's] determination as to the occurrence, cause and amount of such losses, costs, damages or expenses shall be conclusive. As to paper assigned or transferred to [the Bank] without recourse, as long as Debtor is not in default and all statements, representations, and warranties contained in this agreement and the assignments contemplated hereunder are true, Debtor's liability to [the Bank] will be limited to the amount of funds deposited in the reserve account as altered from time to time as hereinafter provided. Every 12 months after the date of this agreement, if Debtor is not otherwise in default, all money in said reserve account in excess of twenty-five percent (25%) of the total unpaid balance on all paper purchased by [the Bank] from Debtor, is payable to Debtor within a period of 14 days upon written request. Until paid under the preceding sentence, Debtor will have no interest in the reserve account and the funds deposited therein are otherwise non-withdrawable by Debtor.

Id. at 141-42 n.2.

185. *Id.* at 145.

186. *Id.*

187. *Id.* at 142. For a discussion of the likelihood that this approach will avoid the bankruptcy risks associated with perfection of security interests in instruments issued by a bank (the *Whiting Pools* risk), *see* part V C *infra*.

188. Apparently *both* the judgment creditor and the bank argued that the U.C.C. con-

sis of U.C.C. sections 9-302(1), 9-305, 9-102(2), and 9-104(k), that while the reserve account was a pledge, the U.C.C. did not apply to pledge or transfer of a bank account as original collateral. Thus, the reserve account arrangement between the bank and the developer had to be analyzed not under the U.C.C., but under the common law of pledge.[189]

Under the common law of pledge, the court pointed out: "[a] pledge is a bailment of goods by a debtor to his creditor, to be kept by him until his debt is discharged."[190]

The court next discussed the common law distinction between pledge and mortgage. In contracts of pledge, possession of personal property is transferred as security only—the pledgor retaining title. In a mortgage, however, title is transferred to the mortgagee, subject to reversion upon performance by the mortgagor. Pledge is a consensual common law "lien" and does not entail a transfer of title.[191] Thus, pledge of a deposit account was akin to pledge of corporate stock, an intangible at common law.[192] The court then traced the history of pledges of intangible property (choses in action), referring to the early conceptual limitation that pledge required physical possession by the creditor of the object pledged.[193] According to the court, this problem has been, in part, resolved through the concept of the "indis-

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trolled the controversy because of a misconception of the nature of a deposit account. Both the creditor and the bank conceived of the deposit account as representing an interest in actual funds on deposit. The creditor argued that since the bank possessed these funds it had to file a financing statement to perfect its security interest. The bank, on the other hand, argued that no filing was necessary under the U.C.C. because it had perfected its security interest by possession of the pledged money. *See* Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d at 142.

189. *Id.* at 143. In its discussion the court in *Duncan Box* relied primarily on two cases: Walton v. Piqua State Bank, 204 Kan. 741, 754, 466 P.2d 316, 327 (1970) (a pledge of a saving passbook) and Wightman v. America Nat'l Bank, 591 P.2d 903, 906 (Wyo. 1979) (pledge of a certificate of deposit). The court further relied on an analysis of the U.C.C.'s exclusion under Article 9 and on U.C.C. § 1-103, which provides that unless particularly displaced by the U.C.C., the principles of law and equity supplement the U.C.C.'s provisions. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E. at 143.

190. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d at 143.

191. *Id.* at 144. This approach is analogous to Judge Hand's classic plea for adherence to proper form in differentiating a mortgage from a pledge. *In re* German Publication Soc'y, 289 F. 509 (S.D.N.Y.), *aff'd*, 289 F. 510 (2d Cir. 1922). Whatever might be said for or against such formalism in that context, see 1 GILMORE, *supra* note 4, § 1.1, at 6-7, which states that "observing the proper forms" in the context of creating a perfected security interest is feasible and would lead to greater precision in the case law and more reliability in structuring financings and the attendant loan loss risk and minimization calculation.

192. The court cited a pre-U.C.C. case for this proposition. Of course the common law has been displaced by the U.C.C. with respect to pledge of stock. *See* U.C.C. § 9-305 (and Comment 1 thereto).

193. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d at 144 (citing Coogan, *supra* note 117, at 1014-15) (to protect creditors against undisclosed interest in property through public notice, physical possession of pledged property was required under the common law; when physical possession was impossible, pledge was impossible).

pensable instrument."[194]

With respect to the pledge of intangibles, like the chose in action created by a bank deposit, the court in *Duncan Box* relied on *Wells Fargo*. This analysis of *Wells Fargo* revealed that the parties clearly intended to grant the bank a security interest in the deposit account by virtue of the written agreement. The only question was as to the adequacy of the transfer of control over the account. Control over the account being exclusively with the bank, the pledge was found to be perfected.[195] The court stated:

> We conclude that where, as here, a bank, by agreement with its depositor, creates a reserve account with the depositor's funds as security for loans made by the bank to the depositor, and retains the exclusive possession and control over the account, such account meets the requirements of a common law pledge.[196]

The undisputed fact of the bank's exclusive control,[197] plus the fact that the developer possessed no document which could enable the developer to transfer all or any part of the account, were sufficient to perfect the bank's security interest against subsequent judgment creditors.[198]

Duncan Box applies the common law notion of pledge in the modern banking context. Although novel in this respect, the decision is unexceptional in its use of common law precedent and in its sound analysis of the underlying legal principles.

The analysis, if not the conclusion, of the court in *Duncan Box* was quite traditional in its common law methodology.[199] Beginning with propositions well within the accepted mainstream of common law pledge, the court first developed the widely accepted contours of pledge. The court went on to discuss how pledge had been applied to intangibles through the use of indispensable instruments, allowing the law of pledge to adhere to its traditional requirement of the transfer of some thing. The court then took the ingenious next (common law) step by concluding that a bank could achieve the functional equivalent of a common law pledge by assignment of and obtaining exclusive control over a deposit account. In reaching this conclusion

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194. *Id.* at 144-45 (citing Annotation, *Effectiveness, as Pledge, of Transfer of Non-Negotiable Instruments Which Represent Obligation*, 53 A.L.R.2d 1396, 1398 (1957); RESTATEMENT OF SECURITY § 1 (1941)). The court recited holdings where common law pledges of deposit account had not been successful because of inadequate transfer of control over the deposit account to the bank. *Id.* (citing *Wightman*, *Walton*, and *Wells Fargo*).

195. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d at 145-46.

196. *Id.*

197. Where a customer has the right to withdraw funds, it would be difficult or impossible to show exclusive control in the bank. *Id.* at 146 (citing Cissell v. First Nat'l Bank, 476 F. Supp. 474, 490-91 (S.D. Ohio 1979)).

198. *Id.* (citing Stevan v. Union Trust Co., 316 F.2d 687, 690-92 (D.C. Cir. 1963); RESTATEMENT OF SECURITY § 28 (1941); 72 C.J.S. PLEDGES § 25 (1987)).

199. *See* Terrebonne, *A Strictly Evolutionary Model of Common Law*, 10 J. LEGAL STUD. 397 (1981); Holmes, *Law in Science and Science in Law*, 12 HARV. L. REV. 443 (1899).

the court, relying primarily on *Wells Fargo*, insightfully extracted control over the asset and notice as the essence of common law pledge. Once these two ingredients were found present to a degree sufficient to satisfy the legitimate policy objectives of perfection, the enlightened court's response was: why not accommodate and protect this bargain under the common law?

The legal principles of *Duncan Box* have attained fairly widespread acceptance throughout the case law[200] and secondary authority.[201] Nevertheless, most of the cases considering whether common law security interests in deposit accounts could survive attack by either the bankruptcy trustee or the IRS have found that while it is possible to create and perfect such a security interest by assignment and pledge, the particular attempts to do so were technically flawed.[202] The cases reveal that bank counsel must exercise great care in creating and perfecting the assignment and pledge.[203]

Six cases decided since *Duncan Box* merit brief discussion to illustrate the generally widespread and rapid acceptance of the *Duncan Box* approach and the need for careful execution of the technical aspects of creating and perfecting a common law security interest.[204] In the first case, *In re Amco Products, Inc,*,[205] the bankruptcy court recognized the first two principles of the *Duncan Box* opinion: (1) the U.C.C. did not control secured financing of deposit accounts as original collateral,[206] and (2) a depositor has only a chose in action against a bank into which it has deposited funds.[207] However, the court went on to find that a bank could not have a lien on its own funds and that unless a non-commingled special trust account was established, a bank could not perfect a security interest in its own funds under

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200. *See In re* CJL Co., 71 Bankr. 261, 264 (Bankr. D. Or. 1987); *In re* Zimmerman, 69 Bankr. 436 (Bankr. E.D. Wisc. 1987); *In re* Riggsby, 34 Bankr. 440, 441 (Bankr. E.D. Tenn. 1983); United States v. Third Nat'l Bank, 589 F. Supp. 155, 158 n.3 (M.D. Tenn. 1984). *Accord* Trust Co. v. United States, 735 F.2d 447, 449 (11th Cir. 1984) (reaching the same conclusions as *Duncan Box* without reference to that case and without as extensive an analysis).

201. Zubrow, *supra* note 9; NICKELS, MATHESON & DOLAN, CREDIT AND PAYMENT SYSTEMS 396, 406-07 (1987).

202. *In re* Zimmerman, 69 Bankr. at 439.

203. None of the cases to date have considered the *Whiting Pools* bankruptcy risk, which is perhaps the critical test of the relative advantages of the *Duncan Box* "reserve account" in the context of a bankruptcy. *See, e.g., In re* All-Way Serv., Inc., 73 Bankr. 556 (Bankr. E.D. Wis. 1987). A bank in this case was held to have a perfected security interest in certain deposit accounts. There is no discussion of the method of perfection, nor discussion of the applicability of 11 U.S.C. §§ 542(a) and 541 to such perfected security interests.

204. A seventh case, Jefferson Bank & Trust v. United States, 684 F. Supp. 1542 (D. Colo. 1988), a tax case which involves the use of the *Duncan Box* approach, is not discussed in the text but is consistent with this developing body of law.

205. *In re* Amco Prods., Inc., 17 Bankr. 758, 760-61 (Bankr. W.D. Mo. 1982).

206. *Id.* at 760-61.

207. *See id.* at 762. Actually, the court recognized this second principle only to the extent of noting that a general deposit became the bank's funds and created debtor-creditor relationship between the depositor and the bank.

Missouri law.[208] Since the special account involved was commingled and used by the bank to make loans, it did not qualify as a special trust account and the bank did not have a perfected security interest.[209]

In re Amco Products is reminiscent of the *Anderson* case of almost a century ago. It implicitly denied the possibility of assigning or pledging choses in action. If what was intended by the parties was not an assignment of an interest in particular funds, but rather—as the facts clearly indicated—an assignment and pledge of the chose in action to the bank, the court's reference to the law of trusts is misplaced and superfluous. The court's reversion to a bailment analysis is inexplicable, considering the attempted assignment was as to the chose in action and not as to the deposited funds themselves. The court ignored the intentions of the parties and found a lack of perfection because it was looking for perfection in the wrong place. It is hard to believe that the courts of Missouri (or any other jurisdiction) will follow this ill-conceived and antiquated analysis. There is simply no good reason to require "reserve account" choses in action to be treated differently from those associated with bank books, certificates of deposits or certified checks.

While the court in *In re Amco Products* was wrong in its analysis of modern common law perfection without an indispensable instrument, the more difficult problem of the *Whiting Pools* bankruptcy risk was not addressed. The critical question would appear to be whether, as a matter of bankruptcy law and policy, the debtor's contingent interest in a reserve account is sufficient to allow the estate to claim a property interest under Bankruptcy Code section 541(a).[210]

In the second case referring to *Duncan Box*, the Ninth Circuit Court of Appeals held under Washington law that although a common law pledge of a deposit account was possible, it required an indispensable instrument to perfect.[211] While the court in *Peoples National Bank* refers to the control entailed in the pledge of an indispensable instrument, it utterly ignores the core of *Duncan Box*, that even absent an indispensable instrument, if there is adequate transfer of control to the bank with no writing capable of misleading other creditors, then common law perfection by pledge should be attainable.

The court in *Peoples National Bank* also concluded that an inadequate assignment of the account had been made since a security agreement constitutes a valid assignment at common law only if it transfers title from the depositor to the bank.[212] The court concluded that no such transfer of title

208. *Id.* at 763.

209. *Id.* at 764.

210. This question will be discussed further in part V C *infra*.

211. Peoples Nat'l Bank v. United States, 777 F.2d 459, 461-62 (9th Cir. 1985).

212. Zubrow, *supra* note 9, at 937. This would appear to be both a miscitation of Zubrow and a misconception of the common law of assignment with respect to deposit accounts.

had occurred: "Here, the security agreement transferred to the bank no more control over, or interest in, the account to the bank than the bank would have had if there would have been no 'agreement.' "[213]

The court went on to distinguish the case it was deciding from a recent Eleventh Circuit Court of Appeals case (decided under Georgia law) in which a tax lien was successfully defeated by a bank with a noninstrumental perfected common law security interest.[214] In that case the agreement apparently provided that the chose in action was delivered, pledged, assigned, conveyed, and transferred to the bank involved, thus renouncing the right to the accounts and transferring them to the bank.[215] There was no such language in the assignment involved in *Peoples National Bank* and therefore it was not "protected at local law against a subsequent judgment lien arising out of an unsecured obligation"[216] as required by the federal tax lien statute.[217] Indeed, at the time the bank had received notice of the federal tax lien, it had not even restricted the debtor-taxpayers' ability to withdraw funds from their account.

While *Peoples National Bank* did not accurately report the scope of *Duncan Box*, this case, like *Wells Fargo*, affirms the possibility of both common law assignment and pledge, albeit on a conceptually more restricted basis than that articulated in *Duncan Box*. Moreover, given the facts of the case, it is apparent that neither the transfer of control necessary for common law pledge nor the transfer of title necessary for common law assignment had been adequately consummated. Given the reluctance to allow perfected security interests in both the bankruptcy and tax lien contexts, banks must at the very least strictly comply with the requirements of the common law.[218] Ultimately, the result in this case is attributable to an inadequately drafted agreement (which did not clearly transfer the account as security) and poor facts (in particular, the failure of the bank to divest the customer of control over the account). Because of its facts, this case leaves open the question whether a sufficient transfer of title and control would prevent the bankruptcy estate from claiming an interest in the account for Bankruptcy Code section 541(a) *(Whiting Pools)* purposes.[219]

In *In re Riggsby*,[220] a Tennessee bankruptcy court noted that a bank can have a security interest in a deposit account, pledged for security under

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213. Peoples Nat'l Bank v. United States, 777 F.2d at 462.

214. *Id.* (distinguishing Trust Co. v. United States, 735 F.2d 447 (11th Cir. 1984)).

215. *Id.* (quoting Trust Co. v. United States, 735 F.2d at 448).

216. Peoples Nat'l Bank v. United States, 777 F.2d at 461 (quoting 26 U.S.C. § 6323(h)(1)).

217. 26 U.S.C. §§ 6323(h)-(i) (1982).

218. The court also held that an unconsummated setoff does not defeat the United States' tax lien. Peoples Nat'l Bank v. United States, 777 F.2d at 462.

219. *See* part V C *infra*.

220. *In re* Riggsby, 34 Bankr. 440 (Bankr. E.D. Tenn. 1983).

the bank's control.[221] However, the court held the *Duncan Box* principle inapplicable to the facts of the case at bar.[222] The court held that a security interest in a regular checking account cannot be "perfected;" it is susceptible only to setoff, which in that case was not timely made.[223]

In yet another case, *United States v. Third National Bank*,[224] the court discussed the law of perfection with respect to tax liens and preferences—that is, what steps are required to give priority against the IRS with respect to funds in an account to which a tax lien has attached. The court concluded that a savings deposit account was a chose in action which was property under local law.[225] The court then inquired whether that property interest had been sufficiently alienated to withstand a government tax levy. Setoff not having been consummated before the tax lien attached, the right was extinguished by the superior attaching tax lien.[226]

The only method by which a bank could defeat a tax lien was by showing: (1) that the bank was not in possession of any of the taxpayer's property subject to levy, or (2) that the taxpayer's property in the bank's possession was subject to a prior judicial attachment.[227] State law determines whether any property rights exist; and when the taxpayer has property rights in an account (*i.e.*, when he has a "chose in action"), the bank will lose. The bank may prevail if: (1) setoff occurs prior to notice of the federal lien (thus eliminating the property interest of the taxpayer), (2) a valid *pledge* takes place (with requirements which vary), or (3) a security interest is obtained by assignment where title to/or control of the funds passes to the bank.[228]

In *Third National Bank*, dicta in a footnote stated that a security interest in a bank account can take priority over a federal tax lien only if the secured party completely cuts off the depositor's access to the funds.[229] The footnote also interprets *Duncan Box* to hold that one may perfect a security interest in a chose in action *either* by assignment or by pledge. Finally, the dicta went on to note that the U.C.C. is inapplicable; that to perfect a security interest, the owner must surrender all control of his bank account; and that joint possession is insufficient.[230]

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221. *Id.* at 441.

222. *Id.*

223. *Id.*

224. United States v. Third Nat'l Bank, 589 F.Supp. 155 (M.D. Tenn. 1984).

225. *Id.* at 157.

226. Tax liens may have priority over a bank's right of setoff where a judgment lien creditor might not have priority. In bankruptcy it is generally not necessary to decide this question because of the preferred status given to an unconsummated setoff under the Bankruptcy Code. *See id.* at 157-58.

227. *Id.* at 157.

228. *Id.* at 157-58.

229. *Id.* at 158 n.3.

230. The approach suggested by the court, essentially that of *Duncan Box*, was adopted

Next, in *In re Union Cartage Co.*,[231] the court explicitly recognized and adopted the analysis of *Duncan Box* respecting pledges. In particular, the court used the *Duncan Box* analysis of "control" to test whether on the facts of the case before it there had been a common law pledge. Finding that the depositor was capable of controlling the account in question at all times, the court concluded that there had not been a *Duncan Box* pledge on the facts of that case, and therefore the bank's interest was subordinate to the bankruptcy estate.[232] The court did not address the *Whiting Pools* bankruptcy risk.

In the final case considered here, Bankruptcy Judge Elizabeth L. Perris followed *Duncan Box* in *In re CJL Co.*[233] That case involved a bank which had issued a back-up letter of credit to secure certain contractual performance by the debtor. In return the bank acquired a security interest in a commensurate deposit account of the debtor.

The bank exercised complete dominion and control over this account through an internal "hold" and gave appropriate notice of its security interest through a restriction reflected on the signature card and on its own records. In the light of these facts, the court determined that the depositor had effectively pledged its chose in action (the intangible property right to withdraw funds) to the bank.[234]

One recent case which did not rely on *Duncan Box* as authority is nevertheless significant to this discussion. In *Gillman v. Chase Manhattan Bank*,[235] New York's highest court upheld a bank's security interest in a deposit account against an assignment for the benefit of creditors under state law without the formalism of bank possession of an instrument incorporating the account. The debtor in *Gillman* had executed a security agreement which pledged to the bank, or gave the bank a general lien or right of setoff against, all right, title, and interest of the debtor in and to the balance of every deposit account of the debtor maintained with the bank as collateral security for a letter of credit.[236] Upon receipt of information indicating that the debtor was experiencing serious financial and managerial difficulties, and had violated certain financial restrictive convenants in the security agreement, the bank (without notice to the debtor) transferred the debtor's

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in a case holding in favor of a similarly situated bank in *Jefferson Bank & Trust v. United States*, 684 F. Supp. 1542 (D. Colo. 1988).

231. *In re* Union Cartage Co., No. 82-105, slip op. at 3-4 (Bankr. N.D. Ohio Sept. 27, 1983) (LEXIS, Bkrtcy library, Cases file).

232. *Id.* at 4.

233. *In re* CJL Co., 71 Bankr. 261, 266 (Bankr. D. Or. 1987).

234. *Id.* at 265.

235. Gillman v. Chase Manhattan Bank, 73 N.Y.2d 1, 534 N.E.2d 824, 537 N.Y.S.2d 787 (1988).

236. The security agreement also provided for the customary good faith acceleration without notice where the bank deemed itself insecure, a "negative pledge" clause, and a subordination agreement. *See id.*

checking funds to an account entitled "Other Demand Deposits" to which the debtor had no access.[237] Significantly, the New York court held that the security agreement signed by the debtor created a common law security interest in the debtor's deposits maintained with that bank. Moreover, the court held that this security interest could be effectuated in good faith without notice to the debtor.[238] However, this case does not determine whether such a security interest is perfected and has priority over conflicting Article 9, bankruptcy, or tax creditors.

Based on this limited review of the case law, some preliminary reflections are offered. First, the two germane bodies of common law are pledge and contractual assignment. Analytically there is some inconsistency between these two bodies of law with respect to the locus of title. In pledge title remains with the pledgor, but in assignment title is transferred to the assignee-bank. The courts, including those relying on *Duncan Box*, have not explicitly addressed this inconsistency. However, as both the *Restatement of Contracts* and Professor Gilmore indicate, where the intention of the parties is to create a security interest by assignment, the locus of title should not be controlling.[239] In either case the grantor's interest in the deposit account is dependent upon performance of the obligation secured by the deposit account.[240]

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237. The bank thereafter dishonored checks drawn against the debtor's regular checking account. *See id.*

238. The court also held that this transfer was not voluntary and therefore did not constitute a preferential transfer in contravention of New York Debtor and Creditor Law § 15 (6-a) (19__). *Id.* at ____, 534 N.E.2d at 833, 537 N.Y.S.2d at 796.

239. 1 GILMORE, *supra* note 4, § 7.5, at 208-09. *Cf.* Maloney v. John Hancock Mutual Life Ins., 271 F.2d 609, 614 (2d Cir. 1959).

The RESTATEMENT (SECOND) OF CONTRACTS defines an assignment as "a manifestation of the assignor's intention to transfer [title] . . . by virtue of which the assignor's right to performance by the obligor is extinguished in whole or in part and the assignee acquires a right to such performance." RESTATEMENT (SECOND) OF CONTRACTS § 317(1) (1979). The Restatement validates the conditional assignment and explains that such a transfer "does not wholly extinguish the assignor's right until the condition occurs." *Id.* at § 331, comment b. *See* Miller v. Wells Fargo Bank Int'l Corp., 406 F. Supp. at 472-73; Macon Nat'l Bank v. Smith, 41 Ga. App. 438, 153 S.E. 446, *conforming to opinion in* 170 Ga. 331, 153 S.E. 4 (1930); Olsen v. Harlan Nat'l Bank, 162 N.W.2d 755 (Iowa 1968) (lack of mutuality case); Jordon v. Lavin, 319 Mass. 362, ____, 66 N.E.2d 41, 44 (1946) (attachment creditor does not have priority over debiting bank); Melson v. Bank of N.M., 65 N.M. 70, ____, 332 P.2d 472, 473 (1958) (lack of mutuality defeated setoff); A. CORBIN, CORBIN ON CONTRACTS §§ 875, 881 (1951).

240. A fascinating set of questions may turn on the locus of title. For example, if title is transferred to the bank by assignment, how does that transfer impact on the mutuality requirement? Consistent with the *Duncan Box* pledge analysis, such a transfer should not destroy mutuality since "real" title is still in the pledgor-depositor notwithstanding that the language of the agreement in *Duncan Box* itself stated an intention to transfer all interest in the reserve account to the bank.

Presumably, the mutuality requirement in 11 U.S.C. § 553 will be construed consistently with state law. But even if this does not happen, it is unlikely that a bankruptcy court would find both that a *Duncan Box* pledge is invalid (unless the applicable state law so holds) and

From a practical standpoint it is simple enough to draft contracts which assign the deposit account and divest the customer of control over this chose in action, leaving exclusive control with the pledgee-assignee financial institution.[241] Language similar to that employed in establishing the "reserve account" in *Duncan Box* would be preferable. That language was noteworthy in that it established that the intent of the parties was to make a full and complete transfer of any and all interest the customer had in the account subject only to a condition subsequent. The customer had no interest in the account until the contractual provisions of the security agreement were completely fulfilled. Such a contingent interest in the "reserve account" is distinguishable from the debtor's interest in the collateral at issue in *Whiting Pools*,[242] and both as a matter of statutory analysis and as a matter of policy should *not* be included within a debtor's bankruptcy estate.[243]

In addition, the bank must attend to the mechanics of the transaction so that it provides sufficient notice to potential creditors, does not make or allow any misrepresentations in memoranda issued by it, and does not otherwise mislead third parties. Indeed, it is suggested that any statement made by the bank to the customer or to third parties (such as accountants) should be accompanied by a boldface notation of the bank's security interest by pledge and assignment and of the fact that the customer does not have any present control over or interest in the account. Denominating the account a "reserve account," by itself, simply may not be enough.[244] In addition, and perhaps most importantly, the agreement should be clear and unequivocal with respect to the intent of the parties, and the bank must *in fact* control the account and keep adequate records of its exclusive control.

The efficacy of pledge as a means for providing notice to potential subsequent creditors has been noted as problematic for quite some time.[245] More recent scholars also have noted this problem in connection with both

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that the account has been transferred sufficiently to destroy mutuality. Thus, in bankruptcy even if an assignment and pledge were deemed inadequate, the bank would probably still have the considerable advantage of unconsummated setoff.

241. In assignment and pledge, exclusive control must be vested in the pledgee-assignee. *See, e.g.*, United States v. Third Nat'l Bank, 589 F.Supp. 155, 158 n.3 (M.D. Tenn. 1984).

242. United States v. Whiting Pools, Inc., 462 U.S. 198 (1983).

243. The collateral at issue in *Whiting Pools* consisted of trucks used in the debtor's business. The application of the *Whiting Pools* analysis to cash collateral is appropriate where the debtor has some use of, control over, title to, and equity in such collateral. *Cf. In re* All-Way Serv., Inc., 73 Bankr. 556 (Bankr. E.D. Wis. 1987) (where none of these existed, the debtor's interests is properly thought of as a "minor interest such as a lien or bare legal title"). With a *Duncan Box* reserve account, it is difficult to argue that the debtor has any meaningful interest in the account, and therefore the rationale of *Whiting Pools* to the effect that the debtor should not be deprived of collateral useful to the reorganization is inapposite. Under *Duncan Box* the "reserve account" is more akin to a prepayment of a loan cost than it is to cash collateral.

244. *See In re* Amco Products., Inc., 17 Bankr. 758, 762 (W.D. Mo. 1982).

245. *See* Coogan, *supra* note 117, at 244.

setoffs[246] and perfected security interests.[247] While the problem cannot be denied, the suggested solution, bringing both setoffs and perfected security interests within the notice filing systems of Article 9, is not presently the law[248] and does not in any event reflect the practical business reality that prospective creditors rely much more extensively on financial statements of prospective debtors than on a central U.C.C. filing system.[249]

As *Duncan Box* suggests, as long as there is no misleading paper issued by a bank claiming a perfected security interest, then notice should not be a problem. In fact, this approach, taken in conjunction with the probable accounting treatment of any deposit account subject to a perfected security interest, should provide adequate notice to a duly diligent prospective creditor. While the accounting treatment for this type of account is not certain, at the very least any certifying accountant should *not* list an encumbered deposit account as "cash or a demand account" without noting that the account is subject to the bank's exclusive control and security interest. Any other accounting treatment would be unfair and misleading given the customary view of cash and deposit account as available assets. Thus, as suggested in *Wells Fargo*, any bank claiming such a perfected security interest should notify any auditor or inquiring prospective creditor of its perfected security interest or be estopped from asserting that right against that creditor.

Strict technical compliance with the governing state's common law requirements in establishing and maintaining these perfected common law security interests is essential. Both in bankruptcy and as to tax liens, the court will certainly submit perfected security interests to detailed scrutiny, given the reluctance to recognize preferred creditor status under both the Bankruptcy Code and the Internal Revenue Code.[250]

7. *Perfection and Fluctuating Balances*

Use of instruments is easy when balances are totally stable, or even when balances change occasionally. In this circumstance the funds held as collateral can be invested in a variety of instruments, including bank-issued instruments such as certificates of deposit or certified checks, as well as third-party-issued instruments such as treasury bills or commercial paper. Occasional rollovers at maturity and safekeeping are the only forms of administration needed. However, when the funds must be used on a regular daily basis, or when the balances fluctuate frequently, use of instruments remains possible but requires more intensive administration. It also involves

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246. *See* Rauer, *supra* note 15.
247. *See* Zubrow, *supra* note 9.
248. An exception is California law regarding setoff.
249. *See, e.g.*, Coogan, *supra* note 117, at 1034 n.84.
250. *Cf. In re* All-Way Serv., Inc., 73 Bankr. at 570-71.

increased voidable preference risks.

Use of bank-issued instruments could be managed as follows: at the beginning of the transaction, the borrower would agree to concentrate all its cash in one demand deposit with the bank. An initial bank instrument would be issued in an amount equal to the borrower's collected cash balances at the close of business on the preceding business day. This instrument probably would be an official bank check drawn in favor of the bank by the bank as pledgee pursuant to authority from the borrower. Upon drawing the check, in accordance with conventional banking practice, the borrower's account would be debited for the full amount and a bank treasurer's account would be credited. On the first day of the transaction, the borrower's deposit balance would open at zero and the bank should be the possessory pledgee of an instrument in a face amount equal to the full credit balance at the end of the preceding day. Deposits collected on this day would be credited to the borrower's own account and checks presented would be paid.

If there were no event of default permitting the bank to realize on its cash collateral (perfected through bank possession of the bank instrument), any need for cash over and above new collections on the particular day would be met by the bank releasing credit as against the instrument. In practice the bank would not constantly reissue the bank instrument every time there was an overdraft. Rather, the bank would honor the overdrafts during the day (so long as they did not, in the aggregate, exceed the amount of the pledged instrument) and then "settle up" as described below at the end of the day. If collections exceeded payments out, the account would end the day in overdraft with a debit balance. At the end of the day, the account would be settled. To cover any overdrafts the necessary cash would be withdrawn from the instrument issued the day before and a new instrument would be issued for the smaller amount and be put in the bank's custody for the next day's cycle. If the account ended the day with a credit balance, that amount would be put into a new instrument in the bank's custody until the next day, and so on.

If a default occurred at any time in this cycle, the bank could exercise its rights by non-judicial foreclosure against the instruments in its custody. If there was a deficiency in the loan thereafter, the bank would have to look to its other collateral or remain an unsecured creditor until either the loan was paid or the bank was willing to dispense with cash collateralization.

If a bankruptcy court intervened before the bank could act, the bank would have a fully perfected security interest in an instrument, and its rights as a secured creditor would not be subject to concerns relating to the statutory security interest, *e.g.*, whether there really was a right of setoff at the commencement of the bankruptcy case, given the possible absence of mutuality. True, the security interest in the bank-possessed instruments might be subject to partial reversal as a preference, to the extent of improvements in position during the ninety days prior to the filing of the bankruptcy petition, but only if the borrower had been insolvent during the requisite period. This position is superior to the right of a consummated setoff because improvements in position are exposed to recapture regardless of whether the borrower was insolvent. However, this position is inferior to an unconsummated setoff. This is so because the "reward" for not making a setoff is reception of a secured claim for the full amount of the balance, and this secured position is not subject to any post-bankruptcy recapture.

In West Virginia (or any other jurisdiction which adopted the *Duncan Box* approach) use of the instrument could be avoided. In such a state it would suffice to put the funds in a *Duncan Box* account where withdrawals are subject to the exclusive control of the bank.[251]

If default or bankruptcy intervened during the day and there were credit balances in the account at the time which were not embedded in the instrument, the bank's claim to a perfected security interest in these funds could not rest on possession of the instrument. With respect to these funds, the bank would have to rely on its setoff rights or on a *Duncan Box* arrangement.

To use *Duncan Box* protection outside West Virginia, the bank should structure its financing as the parties did in *Jefferson Bank & Trust Co.*, as both a pledge and an assignment, and hope that *Duncan Box*'s modern analytical approach to the use of deposit account financing ultimately is adopted under state law.[252] In expectation thereof the bank should create a separate, special reserve account into which the borrower would, by agreement, deposit and concentrate all cash received by it.[253] The *Duncan Box* account would be subject to the exclusive control of the bank. During the day, if there were no default, the bank, acting unilaterally, would allow funds out of the *Duncan Box* account in order to cover items presented. At the end of the day, credit balances in the *Duncan Box* account would be converted into bank-issued instruments, as described above. (In West Virginia or another state which has approved the *Duncan Box* approach, the use of instruments would not be needed.) At the moment of default or bankruptcy, all cash of the depositor would be subject to the bank's perfected security interest on the theory that the dollars embedded in the instrument were perfected by possession and the dollars not in the instrument were perfected in accord with *Duncan Box*.

If bankruptcy were to intervene, the security interest in post-bank-

251. Similarly, the *Duncan Box* approach should work with respect to a tax levy even where account balances vary. Jefferson Bank & Trust Co. v. United States, 684 F.Supp. at 1547.

252. *Id.*

253. Bank lobbying groups might also consider proposing legislative action providing for the option of *Duncan Box* secured financing arrangements. Such legislation would obviously offer the advantage of eliminating the uncertainty inherent in the common law adjudicative process. One such proposal for including security interests in deposit accounts has been preferred. *See generally* Zubrow, *supra* note 9.

ruptcy collections would (except for certain proceeds discussed below) be interdicted by section 552 of the Bankruptcy Code, which cuts off the floating lien on collateral acquired after the bankruptcy case is commenced.[254]

D. *The Relative Ease of Positioning Oneself to Use Each Debt Reduction Method*

Setoff is the easiest method, with respect to the ease with which one can position himself in advance. As long as mutuality of claims and maturity[255] are present, the bank needs to do nothing more than effect the setoff. Debit requires that prior permission to charge the account has been created by contract.

Perfection requires the most complex positioning. There must be a written security agreement, and in most states some arrangement must be made for the issuance of a possessable "instrument."[256] If the deposit account is to have fluctuating balances, complex, expensive-to-administer special arrangements must be made and certain incremental voidable preference risks must be accepted.[257]

V. Using Each Device

A. *Using Debit*

Debiting an account is a routine procedure. The key to use of debit is the scope of the authority given to the bank to make the debit. The right to debit is determined by the contract between the bank and its customer, usually a deposit agreement. The bank would risk liability for acting wrongfully only if the debit were made at a time when the bank was not contractually authorized to do so.

This risk can be minimized by careful drafting. One technique would be to include in the deposit agreement a provision that the bank may debit the depositor's account to collect any amount due the bank whenever the bank deems itself in good faith to be insecure. Another technique would be to authorize the bank to debit whenever any amount due the bank is not paid by the depositor. Depending on the business and negotiating exigencies of each situation, other variations could include the requirement that the bank

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254. 11 U.S.C. § 552 (Supp. IV 1986) does not cut off the lien on funds which represent certain proceeds or other forms of collateral, such as inventory or receivables.

255. Maturity is not required under some circumstances in at least Illinois and New York. Moreover, as discussed *infra*, under the *Manville* definition of "claim," maturity may not be required under the Bankruptcy Code.

256. Whether an indispensable instrument is required depends upon whether a *Duncan Box* approach to attaining a security interest in a deposit account is feasible under local state law.

257. Such risk may have been reduced or eliminated by the 1984 amendments to 11 U.S.C. § 547(c)(2) (Supp. IV 1986).

make prior demand, or that any statutorily mandated grace period must lapse, before the bank could debit.

It should be noted that debit affords many of the benefits of setoff in circumstances where setoff is not legally permissible. For example, a bank cannot set off where there is a third party interest in the account, or where there are uncollected funds in the account. (Both are instances of lack of mutuality.) Yet if the bank bargained for an appropriate agreement with either the third party or the customer, debit would be possible. For example, in the hypothetical suggested *supra*, where the loan debtor is the manufacturing subsidiary and the depositor is the sales subsidiary of the same parent corporation, setoff of an obligation of the former against a deposit of the latter would not be possible because there would be no identity of obligors (*i.e.*, no mutuality). The debt owed *by* the bank would not be owed to the same entity which owed a debt *to* the bank. An agreement to debit could avoid such a lack of mutuality.

B. *Using Consummated Setoff*

To effect a setoff it is first necessary to make all requisite entries on the bank's books. Failure to make the actual book entries can be critical.[258] Determination of the time by which a setoff must be made is affected by the need to set off before the automatic stay in bankruptcy is operative (*i.e.*, before the filing of a bankruptcy petition) and by the following principal factors.

1. *Demand Loans*

If the debt owed the bank is a demand loan, although there is legal authority to the contrary,[259] it is the safer course to make a demand for payment—preferably by telegram or telex or a hand-delivered writing—before implementing the setoff. The notice would probably suffice under the present case law if it were concurrent with implementation of the setoff. Dicta in a New York case, however, indicate a trend toward requiring

258. In *Baker v. National City Bank*, 511 F.2d 1016 (6th Cir. 1975), the chief executive officer of the bank ordered the bank's general counsel to exercise the right of setoff against Penn Central. The order was given by telephone on Saturday, June 20, but the book entries effectuating setoff and notice to the depositor were not accomplished until Monday, June 22. On Sunday, June 21, a petition in bankruptcy was filed with Judge Kraft at his home. At that time the judge signed an order restraining all banks from exercising their rights of setoff. The court held that the bank had not exercised its right of setoff prior to the filing of the bankruptcy petition. *Id.* at 1017. There existed prior to Monday, when the actual entries were made and the notice to the debtor was sent, only the intention to set off, and the bank was barred by the judge's order from carrying out that intention on Monday. *Id. Accord* Jefferson Bank & Trust v. United States, 684 F.Supp. at 1545.

259. *See* Paine-Erie Hosp. Supply, Inc. v. Lincoln First Bank, 82 Misc. 2d 432, 435, 370 N.Y.S.2d 370, 374 (Sup. Ct. 1975); *In re* Dimon's Estate, 32 N.Y.S.2d 239, 243 (Surr. Ct. 1941).

"prior notice and opportunity to pay" before a setoff can be taken on a demand loan.[260]

2. *Time Loans*

If the debt owed to the bank is evidenced by a time note, *Marine Midland Bank v. Graybar Electric Co.*[261] is authority suggesting that the depositor is entitled to "prior notice and opportunity to pay" (*i.e.*, notice of acceleration or of intent to set off and a grace period lasting until the next business day before the setoff may be implemented). Although *Graybar* specifically requires the bank to delay setoff until the day after a time loan is due, the decision is designed to prevent setoff while the depositor could make timely payment of the loan. It is therefore possible that it would be held consistent with the *Graybar* policy to set off on the same day the loan is due, at any time after the bank's offices are open to the public.

It should be noted that in all cases where the loan is subject to an agreement containing a "notices" clause, notices must strictly conform to the requirements of the clause. Section 9-g of the New York Banking Law illustrates the operation of pre-setoff notice requirements. Section 9-g requires that on or prior to the day on which it exercises its right of setoff, the bank must mail to the depositor notice of the setoff and the reason for it. Failure to do so, by the express terms of the statute, does not affect the right of setoff, but could affect the validity of its exercise. Lastly, it should be noted that a creditor's decision to make a full setoff, a partial setoff, or no setoff, is strongly affected by bankruptcy recapture considerations.

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260. In *Marine Midland Bank v. Graybar Elec. Co.*, 41 N.Y.2d 703, 363 N.E.2d 1139, 395 N.Y.S.2d 403 (1977), the bank exercised its right of setoff on July 28, 1972, at around 10:00 a.m., after being advised by its depositor that the depositor would not be able to pay off a term loan maturing on that day. The court said, in holding that the setoff should not have been made until the next day, that:

> The bank's right of setoff may not be exercised until the day after maturity of a time instrument . . . The effect of allowing a setoff on the day a loan matures can only be disruptive and gives the bank an advantage over competing claimants to the fund, an advantage not afforded in the case of judicial remedies under the Uniform Commercial Code.

Id. at 708, 363 N.E.2d at 1143, 395 N.Y.S.2d at 407. The policy expressed in the last sentence may indicate that "notice and opportunity to pay" would also be required in the case of a demand loan. It should also be noted that if a depositor receives such a notice and responds by trying to withdraw or transfer the balances, it would be proper to set off. This statement is based on the theory that "opportunity to pay" is not intended to afford the debtor an opportunity to spirit away the funds. This is analogous to a bank's "freeze" on a debtor's funds in the context of bankruptcy.

261. Marine Midland Bank v. Graybar Elec. Co., 41 N.Y.2d 703, 363 N.E.2d 1139, 395 N.Y.S.2d 403 (1977).

C. *Foreclosure on Perfected Pledge:* Whiting Pools

Although possession of the indispensable instrument representing a deposit account will be sufficient to create and perfect a security interest in the deposit by pledge, it is appropriate to include in a pledge agreement the events of default upon the occurrence of which enforcement of the pledge may take place. Assuming a properly drawn agreement, the full remedies of the common law would then be available.

Pledge combines a power of sale (or with respect to "cash on deposit," its equivalent, the right to debit). The pledgee acts upon a contractual right and recourse to the courts is therefore unnecessary.[262] However, if the amount pledged is inadequate to pay the loan the pledgee may apply for a judgment for the deficiency.[263] *The Restatement of Security* provides in pertinent part: "[u]pon default, the pledgee, in addition to his rights in respect of the enforcement of a claim secured by the pledge, can . . . (b) exercise any special powers of sale which he has been given by the pledgor . . . ."[264] These common law rights are similar to the remedies provided for in Part 5 of U.C.C. Article 9.[265] Such rights upon default do not, however, avoid entanglement of the underlying chose in action within a bankruptcy proceeding, as "property of the state."[266]

This question was addressed in *United States v. Whiting Pools, Inc.*[267] In *Whiting Pools* the Supreme Court decided that property which was subject to a tax lien,[268] and which the IRS had seized but not sold before a bankruptcy petition was filed, nevertheless was property of the bankruptcy estate pursuant to Bankruptcy Code section 541(a)(1).[269] As such, the seized property had to be turned over for use in the Chapter 11 reorganization, subject to the estate providing the IRS with "adequate protection" as determined by the bankruptcy court. The special significance of this case to this article is its broad interpretation of the section 541(a)(1) definition of "property of the estate."

Bankruptcy Code section 541(a)(1) provides that the "estate is comprised of all the following property, wherever located: . . . all legal or equitable interests of the debtor in property as of the commencement of the case."[270] The Court held that this section was intended to include property

262. On the constitutionality of setoff, self-help, state action, and the due process clause, see Clark, *supra* note 27, ¶ 11.4.

263. *See* 2 Gilmore, *supra* note 4, § 43.2, at 1187.

264. Restatement of Security § 48 (1941).

265. U.C.C. §§ 9-501 through 9-507.

266. 11 U.S.C. § 541(a)(1) (1982).

267. United States v. Whiting Pools, Inc., 462 U.S. 198, 211-12 (1983).

268. The tax lien and its operation outside of bankruptcy are discussed in greater detail in part IX *infra*.

269. United States v. Whiting Pools, Inc., 462 U.S. at 209.

270. 11 U.S.C. § 541(a)(1) (1982). "The scope of this paragraph [§541(a)(1)] is broad. It includes all kinds of property, including tangible or intangible property, causes of action . . .

covered by Bankruptcy Code section 542—that is, property which is not possessed by the debtor but which remains, in the words of the Report of the House of Representatives, "property of the debtor."[271] Justice Blackmun wrote for a unanimous court:

> In effect, [section] 542(a) grants to the estate a possessory interest in certain property of the debtor that was not held by the debtor at the commencement of reorganization proceedings. The Bankruptcy Code provides secured creditors various rights, including the right to adequate protection, and these rights replace the protection afforded by possession . . . . Any other interpretation of [section] 542(a) would deprive the bankruptcy estate of the assets and property essential to its rehabilitation effort and thereby would frustrate the congressional purpose behind the reorganization provisions.[272]

Thus, at least in reorganization proceedings,[273] the bankruptcy estate includes property of the debtor which is subject to a creditor's interest and which has been seized but not yet disposed of, including property seized by the IRS.[274]

For the purposes of this article, *Whiting Pools* contains one limitation of potential significance. The Court noted: "if a tax levy or seizure transfers to the IRS *ownership* of the property seized, [section] 542(a) may not apply."[275] In *Whiting Pools* the Court found that the IRS lien and seizure only entitled the IRS to provisional remedies analogous to those of secured creditors under the U.C.C.[276] The Internal Revenue Code's lien does not transfer ownership to the government.[277] In the context of a tax lien, ownership of the property is transferred only when the property is sold to a bona fide purchaser at a subsequent tax sale.[278]

With respect to the *Duncan Box* reserve account, this limitation is significant and favorably dispositive. In such an account, title to the chose in action is assigned to the bank which controls the account. Financings should

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and all other forms of property currently specified in section 70a of the Bankruptcy Act." *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 367, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6323 [hereinafter H.R. Rep. No. 595]; S. Rep. No. 989, 95th Cong., 2d Sess. 82, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5787, 5868.

271. H. R. Rep. No. 595, *supra* note 268, at 367. *See* 4 L. King, Collier on Bankruptcy ¶ 541-72.10 (15th ed. 1982).

272. United States v. Whiting Pools, Inc., 462 U.S. at 207-08.

273. The court took great pains to expressly limit its holding to the application of section 542(a) (and presumably section 541(a)(1)) to the context of Chapter 11 reorganizations, and to exclude Chapter 7 liquidations and Chapter 13 adjustments of debt. *Id.* at 208-09.

274. *See id.* at 209.

275. *Id.* at 209 (emphasis supplied).

276. *Id.* at 211. *See* U.C.C. §§ 9-503, 9-504, 9-506.

277. *Id.* at 210. The Internal Revenue Code's tax sale provision even refers to the debtor as *owner* of the property. *See* 26 U.S.C. § 6335(a) (1982) (emphasis supplied).

278. United States v. Whiting Pools, Inc., 462 U.S. at 211. *See* Bennett v. Hunter, 76 U.S. (9 Wall.) 326, 336 (1869); 26 U.S.C. § 6339(a)(2).

be structured so that the debtor does not technically own the account. Rather, the bank as assignee should have full title to and rights in the account, subject only to a condition subsequent or reversionary interest should the debtor perform fully. Although the chose in action continues in existence, present rights in the chose in action should be renounced by the debtor, since they have been sold to the bank in exchange for the value of the secured loan. Under this analysis a *Duncan Box* reserve account should be excluded from a bankruptcy estate.

This result makes economic sense and good policy. Economically the assignment and pledge of deposit accounts serve as a loan pricing mechanism. The amount of debt covered by these accounts is customarily a proportion of the total loan indebtedness. As in the *Duncan Box* paradigm, loan reserves usually vary directly with the amount of the outstanding loan indebtedness, much like a compensating balance. The economic effect of *Duncan Box* reserve accounts is to increase the bank's true interest rate. Under such an approach the parties have no intent to allow the debtor any use of the reserved amount of the loan. As the loan balance is paid down, the required reserve diminishes proportionately, to the point where once the loan is repaid there is no reserve. The amount of principal repaid is, in part, simultaneously offset by a reduction in the reserve required.[279] From an economic perspective the *Duncan Box* reserve account should not be equated with other security interests, since the debtor is never intended to have any use of the value reflected in the account.

Moreover, it would be bad policy to treat holders of *Duncan Box* accounts like other secured creditors. If *Duncan Box* accounts are included within bankruptcy estates, the result may be to raise the cost of bank credit outside of bankruptcy. This is so because presumably banks and debtors find it economically advantageous to camouflage the true cost of borrowed money. If this advantage is reduced or eliminated, depending upon elasticities of supply and demand, the cost of some bank borrowing could increase.[280] Thus, inclusion of reserve accounts within the ambit of the bankruptcy estate might be bad policy notwithstanding the superficial appeal of treating "similarly situated creditors similarly."[281]

As mentioned above, *Whiting Pools* might be applied differently where bank-issued instruments are involved. The common law pledge of these instruments, as well as perfection by possession under the U.C.C., generally does not transfer ownership to the secured party. Upon default both the

279. For example, if $100 million were borrowed with a ten percent reserve account, when $10 million is due, only $9 million need actually be paid if the debtor is entitled to simultaneous application of the reserve formula ($10 million repaid entitles the debtor to $1 million release in the reserve, leaving a requirement of only $9 million in new value).

280. The empirical nature of this supposition of necessity makes this assertion tentative without actual data.

281. *See* Zubrow, *supra* note 9, at 994.

common law and Article 9 require a foreclosure sale; the provisions of Article 9 also require notice prior to any public or private disposition of collateral.[282] Moreover, the debtor has a common law and statutory right to redeem the collateral prior to disposition.[283] These rights reinforce the conclusion that bank-issued instruments held as security should be included within the property of the estate.

In most cases, however, the significance of this conclusion is limited. Where the bank still enjoys a right of setoff as against the underlying chose in action, the inclusion of these instruments within the estate is of limited consequence in light of the bank's unconsummated setoff right under Bankruptcy Code section 553.[284] Neither the common law nor the U.C.C. appears to require the bank to make an election between foreclosure against the collateral or action on the debt.[285] Thus, the bank ought to retain both its unconsummated setoff right against the chose in action underlying the instrument, and its right to claim any deficiency as an unsecured creditor. Thus, the difference between perfected security interests in instruments and non instrumental perfected security interests is reduced to the possibility that noninstrumental perfected security may escape all entanglement in the bankruptcy proceeding and avoid the vagaries of interim use of the collateral and adequate protection analysis.[286]

VI. Post-Bankruptcy Exposure to Reversal of Pre-Bankruptcy Collection Method

A. *Legal Recapture Theories Available to the Estate: Introduction*

The federal bankruptcy trustee is charged with the duty of marshalling the assets of the bankrupt estate and then distributing those assets in accordance with a plan which treats similarly situated creditors similarly. This is true whether the bankruptcy proceeding is an orderly liquidation under Chapter 7 or a reorganization of the debtor's economic affairs under Chapter 11. In both reorganization and liquidation, preserving the going-concern value is the initial objective of bankruptcy proceedings.

Once a bankruptcy petition is filed, two questions confront a financial institution seeking to use deposit accounts to reduce loan losses. The first question is: what exposure does the financial institution have to possible re-

282. U.C.C. § 9-504(3) provides: "Unless collateral . . . is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale . . . shall be sent."

283. *See* U.C.C. § 9-506; Restatement of Security § 48 (1941); Zubrow, *supra* note 9, at 1010-11.

284. *See* 2 Gilmore, *supra* note 4, § 43.1, at 1181.

285. *Id.*

286. *See* 11 U.S.C. §§ 362(d)(1), 363(c)(2) (1982).

versal or (in bankruptcy terms) "recapture" after bankruptcy? The second question is: what are the financial institution's rights after bankruptcy vis-a-vis other creditors? In this section of the article, the first question will be explored. The second question will be addressed in the next section.

Obviously, from the point of view of the creditor, the best of all possible results is full payment on the obligation owed. The next best are minimization of loss and maximization of recovery, in that order.[287] If any pre-bankruptcy loss minimization is exposed to reversal in bankruptcy, then the utility of that option is reduced.

At the outset of a bankruptcy proceeding, one of the primary responsibilities of the trustee (or DIP) is to marshal the assets of the debtor's estate. This serves the interest of the estate in one and possibly two ways. First, it maximizes the pool of assets available for distribution to creditors. Second, at least in reorganization cases, it enhances the likelihood of successfully reordering the financial affairs of the debtor while preserving a substantial portion of the going-concern value of the estate.[288] The trustee is vested with certain powers to marshal the assets of the estate and indeed to recapture certain pre-bankruptcy transfers which had the effect of preferring certain creditors over other similarly situated creditors.[289] Recapture provisions level the playing field among pre-petition creditors, ensuring that all are treated fairly immediately before (*i.e.*, within ninety days) and during bankruptcy. This sets the stage for equitable treatment under a reorganization plan. Significantly, one of the duties *not* assigned to the trustee is protection of the property rights, such as security interests, of creditors of the estate.

Since at least 1898 the federal bankruptcy trustee has been vested with dual powers. The trustee has whatever property rights the debtor had before bankruptcy, and also whatever rights the creditors of the debtor (and any one of them) had before bankruptcy. Thus, as the grand marshal of the estate, the trustee must maximize the estate by defeating all vulnerable secured or preferential claims against the debtor's property. The trustee must pursue this goal notwithstanding that the federal bankruptcy acts have protected such property interests, even under constitutional mandate. Therefore, in the very structure of federal bankruptcy law there is a tension between the recognition of perfected secured property rights, which prefer

287. Given the declining marginal utility of dollars, recovering lost dollars (*i.e.*, loan principal) ought to rank ahead of recovering interest (*i.e.*, profit). The actual calculus involved for a bank is, however, probably much more complicated, especially in light of the differing goals of loan officers and work-out or bankruptcy personnel. Nevertheless, the theory of declining marginal utility does provide a useful yardstick.

288. For a somewhat critical assessment of the case for reorganization, see Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127 (1986).

289. The concept of equality among similarly situated creditors reflects the "policy of preserving classes [such as secured versus unsecured creditors] and of preserving equality within classes." Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 748 (1985).

certain creditors, and the charge of the trustee and the administrative procedures under the Bankruptcy Code and Rules, which act in tandem to ensure that preferred property rights will be challenged and recognized to the least degree feasible.

Of all the trustee's powers, those of principal concern in this article[290] have to do with the trustee's power to reverse—in whole or in part—consummated setoffs, debits, and voidable perfections of security interests.

The three sections of primary concern are Bankruptcy Code sections 545, 547, and 553. Section 545 invalidates certain liens granted by state statute and may be implicated in respect to "banker's liens" and setoff statutes which automatically deem debt matured as of bankruptcy, such as section 151 of the New York Debtor and Creditor Law.

Section 547, the preference section, covers a wide range of transactions and will be discussed immediately below. Section 553 is the Bankruptcy Code provision applicable to setoffs which are *not* governed by any other Code section.

B. *Debit and Perfection and the Section 547 Preference*

To begin, consider what a section 547 preference is *not*. A section 547 "preference" is not a transfer of property with an intent to defraud other creditors. This is covered by state fraudulent conveyance law incorporated under sections 544(b) and 548 with respect to transfers or obligations incurred with actual intent to hinder, delay, or defraud.

The classic example of a preference is payment of a debt by an insolvent. No intent to defraud is necessary. A preference arises from the transfer of property by the presumptively insolvent debtor to the bona fide creditor, because the transferee-creditor gets more than his "fair" share of the debtor's assets.[291]

For example, suppose the debtor has assets of $1 million, liabilities of $5 million, and five creditors, each of whom is owed $1 million of unsecured debt. If the presumptively insolvent debtor pays any one of his five creditors the $1 million he owes that creditor, there would be no assets available for the other four creditors. Note that there is no wrongdoing in this payment: a $1 million debt is due and owing to the preferred creditor and he is paid.

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290. The trustee's marshalling function and powers include such things as turn-over proceedings and recapture of fraudulent conveyances, as well as the trustee's status as a hypothetical judgment lien creditor. For the most part these illustrative powers are beyond the scope of this article.

291. The central policy objective of the Bankruptcy Code's preference rules is to "facilitate the prime bankruptcy policy of equality of distribution among creditors of the debtor." H.R. Rep. No. 595, 95th Cong., 1st Sess. 178, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6138. *See, e.g.*, D. Baird & T. Jackson, Cases, Problems, and Materials on Bankruptcy 316-18 (1985).

Nor is there any net diminution in the estate; before the payment there was a net deficit of $4 million and after the payment there is a net deficit of $4 million. The only objection which can be made to this payment is that it is "unfair" to similarly situated creditors in that it prefers the one paid creditor to the four totally unpaid creditors.[292] The extent of the preference is $800,000, the excess the paid creditor received over what he would have received had all five creditors been treated "fairly."[293] Thus, "preference" means the extent to which one creditor has received more than his fair share on liquidation and distribution of the debtor's assets. With this illustration in mind, let us consider how section 547 operates on debit and perfection.[294]

1. *Voidable Preference Explained*

A "voidable preference" is defined in section 547 of the Bankruptcy Code.[295] It occurs at the time that the transfer was made (see below) and exists if the following conditions are met: (1) there is a transfer of any of the debtor's property; (2) to or for the benefit of a creditor; (3) for or on account of an antecedent debt; (4) while the debtor was insolvent; (5) within ninety days of bankruptcy; and (6) the transfer must enable the creditor to receive more than the creditor would have received in a liquidation case under Chapter 7 of the Bankruptcy Code.

For the purposes of the Bankruptcy Code, a transfer is deemed to have been "made" when perfected as against other parties. Thus, in the case of perfection of a security interest in a cash deposit through delivery of an indispensable instrument (such as the creation and transfer of a certificate of deposit), the date on which the transfer was "made" would be the date on which the instrument was conveyed to the bank. In the case of the transfer of funds from the debtor's account to the bank through the exercise of debit, the transfer would be viewed as having been made on the date of the debit entries.[296] A security interest perfected through one of the methods outlined above will not be voidable as a preferential transfer if it was created and perfected at the time the loan was entered into, because in that case it will

292. The idea that unlucky participants in an unanticipated catastrophe should bear an equal burden of the losses may be as old as the idea of the law itself. (Consider, *e.g.*, the institution of general average in maritime law: those with an interest in a wrecked ship and its cargo shared the salvage value ratably with their investment.) There was no common law doctrine which made preferences unlawful or voidable. To make preferences unlawful was one of the principal objects of the nineteenth century bankruptcy acts. 2 Gilmore, *supra* note 4, § 45.3.5, at 1298.

293. This calculation assumes that there are no additional transaction costs, such as administrative expenses and the like, in distributing the assets "fairly."

294. 11 U.S.C. § 547 (1982) cannot apply to setoff since section 547 applies only to certain pre-bankruptcy "transfers" of the debtor's assets. The word "transfer" is defined to exclude setoffs. The legislative history also supports this conclusion.

295. 11 U.S.C. § 547(b) (1982 & Supp. IV 1986).

296. Some entries are sufficient. Completion of the process is probably not necessary.

not be made for an "antecedent debt."

2. *The Elements of and Exceptions to Section 547 Preference*

Section 547 prescribes five necessary elements which a bankruptcy trustee must prove in order to avoid a transfer as a preference under section 547.[297] A transfer is preferential if it is: (1) made to a creditor; (2) on account of an antecedent or pre-existing debt; (3) while the debtor is insolvent; (4) on or within ninety days of filing the bankruptcy petition (unless an insider is involved, in which case the period is a year); and (5) it enables the creditor to receive more than the creditor would receive if the estate were liquidated under Chapter 7 of the Code.[298] Although element (1) is not

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297. 11 U.S.C. § 547(g) (1982 & Supp. IV 1986) allocates this burden of proof to the trustee.

298. In pertinent part 22 U.S.C. § 547 (1982 & Supp. IV 1986) provides:

(a) In this section—

. . . .

(2) "new value" means money . . . or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation;

(3) "receivable" means right to payment, whether or not such right has been earned by performance; and . . .

. . . .

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in the property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or *within 90 days before the date of the filing of the petition*; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider;

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 [liquidation] of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

(c) The trustee may not avoid under this section a transfer-

(1) to the extent that such transfer was—

(A) *intended* by the debtor and the creditor to or for whose benefit such transfer was made to be *contemporaneous exchange for new value given to the debtor*; and

(B) in fact a substantially contemporaneous exchange;

(2) to the extent that such transfer was—

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial afairs of the debtor and the transferee;

without its complexity given the broad definition of creditor,[299] this element will ordinarily be satisfied in the context of debits or perfections by banks.[300] Similarly with respect to element (3), the trustee is given the bene-

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(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms;

(3) that creates a security interest in property acquired by the debtor—

(A) to the extent such security interest secures new value that was—

(i) given at or after the *signing of a security agreement* that contains *a description of such property* as collateral;

(ii) given by or on behalf of the secured party under such agreement;

(iii) given to enable the debtor to acquire such property; and

(iv) in fact used by the debtor to acquire such property; and

(B) that is *perfected on or before ten days after the debtor receives possession of such property*;

(4) to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor—

(A) not secured by an otherwise unavoidable security interest; and

(B) on account of which new value the debtor did not make an otherwise unavoidable transfer to or for the benefit of such creditor . . .

. . . .

(6) that is the fixing of a statutory lien that is not avoidable under section 545 of this title; or

. . . .

(e) . . . .

(2) For the purpose of this section, except as provided in paragraph (3) of this subsection, a transfer is made—

(A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is *perfected at, or within 10 days after*, such time;

(B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or

(C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—

(i) the commencement of the case; or

(ii) 10 days after such transfer takes effect between the transferor and the transferee.

(3) For the purpose of this section, *a transfer is not made until the debtor has acquired rights in the property transferred.*

(f) For the purpose of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

(g) For purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section, and the creditor or party in interest against whom recovery or avoidance is sought has the burden of proving the nonavoidability of a transfer under subsection (c) of this section. [Emphasis supplied]

299. 11 U.S.C. § 101(9) (1982 & Supp. IV 1986). *See In re* Big Three Transport, Inc., 41 Bankr. 16 (W.D. Ark. 1983); B. Weintraub & A. Resnick, Bankruptcy Law Manual, ¶ 7.05 [2][a] (rev. ed. 1986 & Supp. 1988) (and cases cited) [hereinafter B. Weintraub & A. Resnick].

300. Setoff is excluded from the definition of transfer, which is defined in 11 U.S.C. § 101(50) (Supp. IV 1986) as: "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of

fit of a rebuttable presumption of insolvency during the preference period,[301] and therefore this element will turn uniquely on the facts of each case. Elements (2), (4), and (5) require some limited discussion.

Element (2)—the transfer must have been made on account of antecedent or pre-existing debt—derives from the assumption that a transferee-creditor who has contemporaneously contributed equivalent new value to the debtor in exchange for transferred assets has not been preferred to other creditors because the value of the estate has been enhanced to the extent of the new value. So, for example, if a new loan is extended to a debtor who immediately pledges to a bank a deposit account of equal value, there has been a transfer, but there was no preference because the transfer was not on account of an antecedent debt. The asset transfer was contemporaneous with the extension of new value. Debit (more often than perfection) will be associated with a transfer on account of a pre-existing debt.[302]

As to element (4), putting to one side special circumstances where a bank could be considered an "insider,"[303] generally transfers on or within ninety days of the filing of the petition are potential preferences. In some instances it can be difficult to determine when the interest in the debtor's property is transferred[304] or the debt is incurred.[305] As to perfection, it will be achieved on the day of the last act necessary to perfect the common law security interest. As to debit, it will take place on the day the debit is completed, including sufficient entries in bank books.

Finally, with respect to element (5)—the transfer must enable the creditor to receive more assets than it would have received under a Chapter 7 liquidation[306]—it must be determined that the creditor's claim would have been allowed and that it would not otherwise have had a priority.[307] While

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redemption."

301. 11 U.S.C. §§ 547(f), 547(b)(3), 101(31) (1982 & Supp. IV 1986).

302. Actually determining the date on which a debt is incurred (and therefore whether a debt is an antecedent debt) can be extremely complicated. The Bankruptcy Code does not define when debt is incurred. One court has determined that it takes place on the date of contract, Eckles v. Pan Am. Mktg (*In re* Balducci Oil Co.), 33 Bankr. 843, 846 (Bankr. D. Colo. 1983), while another has determined that it takes place on the date when the amount due under a utility contract was fixed, Thomas W. Garland, Inc. v. Union Elec. Co. (*In re* Thomas W. Garland, Inc.), 19 Bankr. 920, 928 (Bankr. E.D. Mo. 1982). Professor Herbert has noted that the commonly accepted phrase that the debt is incurred when "the obligation to pay becomes legally binding" is as illusory a determinant as the word "incurred" itself. Herbert, *The Trustee Versus the Trade Creditor: A Critique of Section 547(C)(1), (2) & (4) of the Bankruptcy Code*, 17 U. Rich. L. Rev. 667, 681 (1983).

303. "Insider" is defined in 11 U.S.C. § 101(28) (1982).

304. *See, e.g.*, *In re* Duffy, 3 Bankr. 263, 265 (Bankr. S.D.N.Y. 1980) (post-dated check not transferred until date of payment by bank; no delivery of check).

305. *See, e.g.*, *In re* Iowa Premium Serv. Co., 695 F.2d 1109 (8th Cir. 1982) (*en banc*) (debt for interest payment incurred not when note was executed but when interest accrued).

306. *See generally*, *In re* Lewis W. Shuntleff, Inc., 778 F.2d 1416 (9th Cir. 1985).

307. *See* 11 U.S.C. §§ 502 & 507 (1979).

these two determinations can be intricate, in general debit or voidable perfection will be involved in connection with allowable claims which will usually not otherwise have priority, with the major exception being the rules pertaining to unconsummated setoff. Thus, depending upon the facts of the particular case, the trustee may or may not be able to satisfy this element.[308]

Assuming the trustee is able to satisfy all five preference elements, the burden shifts to the creditor (*i.e.*, the bank) to establish that the transaction fits within one of the exceptions listed in Bankruptcy Code section 547(c). Section 547(c)(1) declares that the trustee may not avoid transfers which are intended by the debtor and the creditor to be contemporaneous exchanges of new value and which, in fact, are substantially contemporaneous exchanges. While this exception is not free from its interpretive problems, it essentially excepts contemporaneous transfers of assets for new value on the theory discussed above. Generally, voidable perfection may have a chance under this exception, but debit generally would not have a chance in light of the requirement that the parties must intend that the transfer be contemporaneous.

Bankruptcy Code section 547(c)(3) is the bankruptcy counterpart to a purchase money security interest under the U.C.C.[309] In general this section is not pertinent to the use of perfection or debit. Similarly, Bankruptcy Code section 547(c)(4) concerns transfers of already encumbered assets for new value. While it may be pertinent to this inquiry, it is merely a refinement of the exchanges for new value discussed above. Bankruptcy Code section 547(c)(5) concerns inventory and receivables and is discussed below. Pledges and assignments which do not take place contemporaneously with the extension of credit may be deemed to have been for an antecedent debt; generally pledges and assignments which are contemporaneous with extensions of new value will not qualify as preferences.[310] Because of the very nature of debit, this element will be satisfied more often than not. Debit will almost always be used some time after the debt is incurred.

Bankruptcy Code section 547(c)(6) is also of relatively little concern, save for its possible application to laws like section 151 of the New York Debtor and Creditor Statute to the extent that this law makes a setoff a statutory lien[311] not avoidable under section 545 of the Bankruptcy Code. Bankruptcy Code section 547(c)(7) excludes consumer debt under $600 and while noteworthy it is not significant to the commercial loans discussion herein. This leaves only Bankruptcy Code section 547(c)(2) for

308. There is some authority for the proposition that projected administrative expenses, which have a priority, should be deducted before calculating the hypothetical Chapter 7 liquidation distribution. *See In re* Independent Clearing House Co., 41 Bankr. 985, 1013 (Bankr. D. Utah 1984).

309. U.C.C. §§ 9-107, 9-301(2).

310. 11 U.S.C. § 547(c)(2)(B) (1979).

311. Statutory lien is defined in 11 U.S.C. § 101(45) (1982).

consideration.

As amended in 1984, section 547(c)(2) excludes from avoidance as a preference debt incurred in the "ordinary course of business" of the debtor and the transferee.[312] Also excluded are debts incurred in the ordinary course of the debtor's "financial affairs."[313] While this exclusion does not readily apply to debit, since the triggering event for a debit is not likely be in the ordinary course of a debtor's business, this exception may provide some substantial protection to voidable perfection if the transfer is within the ordinary course of both the debtor's and the bank's business.[314] Although litigation over the meaning of this section can be expected,[315] there is case law on the question of defining the ordinary course of a debtor's business.[316]

In a well reasoned opinion involving the Manville bankruptcy, Judge Burton R. Lifland provides some guidance on ordinary course of business analysis which is useful here. In *In re Johns-Manville Corp.*,[317] the bank-

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312. 4 COLLIER ON BANKRUPTCY ¶ 547.38 (15th ed. 1985).

313. Prior to the 1984 amendment, the Bankruptcy Code also required that the transfer was made not later than forty-five days after such debt was incurred. This additional requirement was dropped in 1984 for cases commencing after October 7, 1984. In addition the 1984 amendments added the language with respect to "financial affairs" to make it clear that the exception applied to both commercial and consumer debtors.

314. A debate is currently raging among legal scholars over whether the section 547(c)(2) exception applies to repayments of long term debt. Most commentators have concluded that it does. *See, e.g.*, D. BAIRD & T. JACKSON, CASES, PROBLEMS, AND MATERIALS ON BANKRUPTCY 317-18 (1985); CLARK, *supra* note 27, ¶ 6.4[2][a], at 6-16; R. JORDAN & W. WARREN, BANKRUPTCY 321 (1985); DeSimone, *Section 547(c)(2) of the Bankruptcy Code: the Ordinary Course of Business Exception Without the 45-Day Rule*, 20 AKRON L. REV. 95, 129 (1986); Gorney, *Elimination of the 45-Day Rule: Amendment of Section 547(c)(2) Requires a New Look at Preferences*, 91 COM. L.J. 364, 368 (1986); Herbert, *The Trustee Versus the Trade Creditor II: The 1984 Amendment to Section 547(c)(2) of the Bankruptcy Code*, 2 BANKR. DEV. J. 201, 213 (1985); Morris, *Substantive Consumer Bankruptcy Reform in the Bankruptcy Amendment Act of 1984*, 27 WM. & MARY L. REV. 91, 122-23 (1985); Weintraub & Resnick, *Preferential Payment of Long-Term Debts in the Ordinary Course of Business—The Effect of the 1984 Amendments*, 17 U.C.C. L.J. 263, 264 (1985) ("The effect of this 1984 amendment is that the ordinary course of business exception to the preference rule now applies to long-term as well as short-term debt."). Some commentators have argued that the section 547(c)(2) exception does not apply to long-term debt or does so only within limits. *See* Broome, *Payments on Long-Term Debt as Voidable Preferences: The Impact of the 1984 Bankruptcy Amendment*, 1987 DUKE L.J. 78; Duncan, *Loan Payments to Secured Creditors as Preferences Under the 1984 Bankruptcy Amendments*, 64 NEB. L. REV. 83, 90 (1985). Professor Countryman endorses the first group, but advocates for policy reasons the repeal of section 547(c)(2) because it creates a "gaping hole." Countryman, *The Concepts of a Voidable Preference in Bankruptcy*, 36 VAND. L. REV. 713, 722 (1985).

315. Countryman, *The Concepts of a Voidable Preference in Bankruptcy*, 36 VAND. L. REV. 713 (1985).

316. *See, e.g.*, Aguillard v. Bank of Lafayette (*In re* Bourgeois), 58 Bankr. 657 (Bankr. W.D. La. 1986) ("ordinary course refers to the debtor's normal business operations of selling or providing services, not borrowing money").

317. *In re* Johns-Manville Corp., 60 Bankr. 612 (Bankr. S.D.N.Y. 1986) (Lifland, C.J.).

ruptcy court considered whether retention (and ultimately payment) of Washington-based lobbyists was in the ordinary course of business for the debtor and debtor-in-possession, Manville, under section 363 of the Bankruptcy Code.[318] After observing that the term "ordinary course of business" is *not* defined in the Bankruptcy Code, the court synthesized the existing case law to develop a "workable analysis to be used in deciding whether an activity is within the debtor's 'ordinary course of business,' " and went on to discuss some parameters applicable to such a determination. At least within the context of a Chapter 11 reorganization, "[t]he analysis, using 'vertical' and 'horizontal' components, embodies the elastic rehabilitation policies of the Code yet respects its boundaries."[319] The vertical dimension adopts the vantage point of "a hypothetical creditor and inquires whether the transaction subjects [such] a creditor to economic risks of a nature different from those he accepted when he decided to extend credit."[320] Pre-petition business practices are germane since "[t]he primary force of the vertical dimension is . . . on the debtor's internal operations and workings."[321] In other words: is this the kind of business transaction a creditor would expect, knowing the internal operations of this business? The "horizontal dimension" compares the debtor's business and other similarly situated businesses.[322]

This analysis has interesting implications when a debtor has granted a security interest in its deposit accounts. For example, does the "vertical dimension" make the probable expectations of creditors (with respect to the likelihood that deposit accounts are encumbered) influential in determining whether the transfer was in the ordinary course of business? Does the view of such a hypothetical creditor depend upon its level of sophistication concerning financing alternatives and the financial condition of the debtor? Does this hypothetical creditor's expectation establish a kind of implicit reliance interest based on a hypothetical assumption made by general creditors that deposit accounts are generally unencumbered? Does the notice, if any, provided by the bank or the debtor concerning this encumbrance impact upon what a hypothetical creditor could or could not reasonably expect?

The horizontal dimension is somewhat less troubling because, while the necessary information about similarly situated businesses may be somewhat difficult to obtain if the bank cannot draw on its own client data base, pre-

318. 11 U.S.C. § 363(c)(1) (1982) allows the trustee or debtor-in-possession, as the case may be, to use property of the estate in the ordinary course of business.

While the author was *not* involved in this litigation, the author was involved in the Manville reorganization at its earlier stages as an associate with co-counsel for the debtor-in-possession, Davis, Polk & Wardell.

319. *In re* Johns-Manville Corp., 60 Bankr. at 616.

320. *Id.*

321. *Id.* at 617.

322. *Id.* at 618.

sumably other similarly situated businesses will also be using financing secured by deposit accounts.

The usefulness of the Bankruptcy Code section 547(c)(2) exception will have to await some further clarification of the meaning of "vertical dimension" and "horizontal dimension" in connection with financing mixes. Nevertheless, this exception is potentially useful to defeat a trustee's preference attack, particularly with respect to transfer due to fluctuating balances "in the ordinary course of business."

3. *Perfection Avoidance*

By definition non-voidable perfection involves a perfected security interest which, for temporal reasons, is not subject to the trustee's power to recapture a "preferential" transfer. Thus, for example, most perfections completed more than ninety days before the bankruptcy petition is filed will be beyond the trustee's reach. Of course, given the uncertainties associated with the typical bankruptcy filing, a bank can never be certain until this time has elapsed whether it has a non-voidable or a preferential perfection. Therefore, all perfected security interests must be considered as potentially within Bankruptcy Code section 547's reach until they have seasoned for ninety-one days.

An implicit complexity is created by fluctuating balances in deposit accounts.[323] If the amount in a deposit account as to which a bank has perfected a security interest rises during the preference period, section 547 would apply, at least to the extent of such increase, and potentially subject the transfer to recapture. This problem can be exacerbated by other interim deposits and deductions. Where fluctuating balances are anticipated (for example, where the amount of collateral is tied to the outstanding balances of the loan), the bank would have to rely on either the contemporaneous exchange exception or the ordinary course of business exception. In any event, fluctuating balances are at greater risk of recapture precisely because they are potentially a subspecies of voidable perfection.[324]

Voidable perfection involves a perfected security interest in a deposit account which is potentially subject to recapture under section 547 as a preference. Whether voidable perfection qualifies as a section 547 preferential transfer will for the most part turn on whether the transfer is for or on account of an antecedent debt. This will depend upon whether new values are extended to the debtor contemporaneously. A particular preferential perfection usually will or will not be a section 547 preference depending

323. As discussed *infra*, common law perfection through the use of indispensable instruments can (if structured properly) contain the problem of fluctuating balances to the extent that choses in action are frozen in amount for more than ninety-one days.

324. In addition, where a *Duncan Box* pledge is relied upon, a bank must be careful not to relinquish control or the appearance of control over the deposit account. *Cf.* Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548, 561-63 nn.17-18 (2d Cir. 1976).

upon whether new value is contemporaneously extended with the transfer of the perfected security interest in the chose in action.

Of course, this determination does not end the necessary inquiry. As can be inferred from the innovative discussion in *Manville*, even a preferential transfer *may* come within the ordinary course of business exception.

4. *Recapture of Debits*

Debits are extremely vulnerable to a section 547 preference attack. By their very nature debits will not be exchanges for contemporaneous new value and will not be in the ordinary course of business in light of the *Manville* analysis.

C. *Recapturability of Consummated Setoffs*

Section 553 of the Bankruptcy Code continues the long-recognized right of setoff for mutually due and owing (*i.e.*, mature) cross obligations both of which arose prior to bankruptcy.[325] The word "recognition" reflects the fact that the Bankruptcy Code does not create any independent right of setoff. Rather, it simply incorporates by reference whatever right to setoff a creditor may already have under state law.[326]

The Bankruptcy Code's recognition of the right of setoff can be of considerable advantage to a bank in minimizing loan loss in the event of bankruptcy. This is so because the creditor is allowed full dollar value credit against whatever it owes to the depository customer, and in addition setoff diminishes the trustee's claim to collect from the bank the debt owed by it to the bankruptcy estate.[327] Thus, "a setoff has the effect of paying one creditor more than another . . . and setoffs are . . . approved because they

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325. Since at least the late seventeenth or early eighteenth century commissioners in bankruptcy may have admitted setoffs between the bankrupt and a creditor to the extent of the smaller claim. Loyd, *The Development of Set-off*, 64 U. Penn. L. Rev. 541, 547 (1916).

326. In pertinent part 11 U.S.C. § 553 (1982) provides:

> (a) Except as otherwise provided in this section and in Sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a *mutual debt* owing by such creditor to the debtor that *arose before the commencement of the case* under this title against a claim of such credit against the debtor that arose before the commencement of the case . . . .

(emphasis supplied).

327. Thus, for example, where the bank owes the depository customer $A and the customer owes the bank $B, through exercise of its right of setoff the bank may recover the full dollar value of its claim against the depository customer up to the limit of the smaller of A or B. In effect this results in one-hundred-percent recovery on the bank's claim against the bankruptcy estate up to that limit. This percentage on an allowed unsecured claim could, of course, be substantially in excess of the percentage of recovery distributed on other unsecured claims. In addition, the bank does not have to turn over $A to the bankruptcy estate, assuming A is greater than B. In any event the bank would only have to turn over the amount by which A exceeded B, if any.

are based upon long-recognized rights of mutual debtors."[328]

While the Bankruptcy Code recognizes common law setoff,[329] it does so within certain limitations. For example, setoffs made within ninety days of bankruptcy are vulnerable under Bankruptcy Code section 553 to recapture by the bankruptcy trustee of the "insufficiency."[330] One treatise states:

> [S]pecifically, if the creditor offsets mutual debts on or within ninety days before the commencement of the case, the trustee may recover from the creditor the amount set off to the extent that any insufficiency on the date of the setoff is less than the insufficiency ninety days before the petition is filed or, if there is no insufficiency ninety days before bankruptcy, when there is an insufficiency for the first time within the ninety-day period. The term "insufficiency" means the amount by which a claim against the debtor exceeds the amount of the mutual debt owed to the debtor.[331]

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328. *In re* Bohack Corp., 599 F.2d 1160, 1165 (2d Cir. 1979).

329. There are certain exceptions not pertinent to this discussion with respect to disallowed and transferred claims and those made for the purpose of enhancing the creditor's setoff. Pertinent to those exceptions, 11 U.S.C. § 553 (1982) provides:

> (a) . . . except to the extent that—
>
> (1) the claim of such creditor against the debtor is disallowed other than under Section 502(b)(3) of this title:
>
> (2) *such claim was transferred*, by an entity other than the debtor, to such creditor—
>
> (A) *after the commencement of the case*; or
>
> (B) (i) after *90 days before the date of the filing* of the petition; and
>
> (ii) *while the debtor was insolvent*; or
>
> (3) the *debt owed* to the debtor by such creditor *was incurred* by such creditor-
>
> (A) *after 90 days before the date of the filing* of the *petition*:
>
> (B) while the *debtor was insolvent*: and
>
> (C) *for the purpose of obtaining a right of setoff against the debtor.*
>
> . . . .
>
> (c) For the purpose of this section, the debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

(emphasis added).

330. In pertinent part 11 U.S.C. § 553 (1982) provides:

> (b)(1) Except with respect to a setoff of a kind described in Section 362(b)(6) or 365(h)(1) of this title, 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.

(emphasis added).

331. B. Weintraub & A. Resnick, *supra* note 298, ¶ 5.10[2], at 5-43. The authors of this

This recapture provision of section 553 was intended to avoid undue advantage to banks resulting from the happenstance that bankruptcy occurs while balances are fluctuating, and to eliminate the need to prove any attempt to prefer a debtor's financial institution. Note that Bankruptcy Code section 553(a)(3) requires both that the debt was incurred within the ninety-day period *and* that the increase in the deposit account was for the *purpose* of enhancing the bank's setoff advantage.

More importantly, section 553(b)(1)'s recapture provision was intended to deter consummated setoffs by causing forfeiture of the bank's enhanced advantage during the ninety-day period. For example, Bankruptcy Code section 506(a) rewards the bank which does not consummate a setoff by allowing it the full dollar value of its setoff right as a preferred claim within the bankruptcy proceeding itself.

This dual approach is appropriately referred to as the carrot (the preferred bankruptcy claim) and the stick (the recapture of recapture period decreases in insufficiency). The carrot and the stick were adopted to discourage the exercise of pre-bankruptcy setoffs by creditors (mainly banks) by rewarding those creditors which abstain from exercising their rights, since the exercise of setoff rights can themselves precipitate cash flow and credit problems of the sort which may themselves create a need for bankruptcy protection.

1. *The Carrot—Statutory Incentives to Refrain from Setoff*

To reward a bank which has a right to,[332] but does not make, a setoff, section 506(a) of the Bankruptcy Code gives the bank a security interest in deposit balances which could have been—but were not—set off before bankruptcy. Under the statute and the cases, the secured claim to balances not set off is entitled to "adequate protection" against declines in value and is not subject to recapture of improvements in position during the preference period.[333] There are a number of problems in determining whether statutory protection is truly "adequate"—*e.g.*, judicial determinations of the adequacy

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treatise on bankruptcy offer three illustrations of the operation of section 553's recapture provisions. These illustrations demonstrate how recapture works with varying "insufficiencies" throughout the ninety-day recapture period. The insufficiency rule uses the ninety days (or the first time within that ninety days that there is an insufficiency) as a ceiling and refuses to allow the bank any improvement over that ceiling (*i.e.*, any reduction in its remaining claim). Thus, assuming a constant loan balance, if the insufficiency—the net amount after a hypothetical setoff ninety days before bankruptcy—was $X, the trustee is allowed to recover only if the amount of the insufficiency is reduced to $Y during the ninety-day period, and he may recover only the amount by which $X exceeds $Y.

332. For the "right" to exist, there must have been mutuality before the bankruptcy filing and possibly maturity, depending upon whether the *Manville* definition of "claim" is applied in this context.

333. *See, e.g.*, Big Bear Super Market v. Princess Banking Corp. (*In re* Princess Banking Corp.), 5 Bankr. 587, 842 (S.D. Cal. 1980) (Meyers, B.J.).

Congress intended might not include full economic compensation (including opportunity costs).[334] This article assumes that genuine "adequate protection" will be provided for the "cash" collateral deposit account.[335]

2. *The Stick—Statutory Disincentives to Setoff*

To discourage setoff, section 553 of the Bankruptcy Code permits the bankrupt estate to recapture setoffs to the extent that the bank improved its position by setting off during the ninety days before bankruptcy.[336] (Even though the statute permits the recapture litigation, it is possible that for practical reasons, no setoff recapture litigation would ever be commenced.)

For example, if the loan is $10 million and the balances are $5 million on the ninetieth day before the bankruptcy petition is filed, and if the loan is $10 million and the balances are $6 million on the date of setoff, the improvement in position would be $1 million. (The amount of improvement in position would be the same if the balances had been steady at $5 million, but they had been paid down by $1 million.) On the first set of facts (where the balances rise), a $5 million setoff would be immune from reversal, but if a $6 million setoff were made, $1 million could be recovered by the bankrupt estate. On the second set of facts (where the loan principal declines), a $4 million setoff could be made, but $1 million could be recovered by the bankrupt estate.

The Bankruptcy Code draftsmen did not specify whether the bank should use book balances or collected balances in its calculations of improvement in position. In one case addressing this issue, the holding was adverse to the banking industry. In *Citizens Fidelity Bank & Trust Co. v.*

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334. *See* Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L.J. 857, 871-77 (1982) ("It is likely, therefore, that the compensation that is deemed to be 'adequate protection' will rarely provide the secured creditor with the indubitable equivalent of realizing, at the point of bankruptcy, the market value of the item in which that creditor has a security interest.").

335. Actually some courts have adopted academic approaches to the adequate protection problem which are encouraging. *See, e.g.*, Grundy Nat'l Bank v. Tandem Mining Corp., 754 F.2d 1436 (4th Cir. 1985)(adequate protection may be provided by requiring a trustee to make periodic cash payments, providing a replacement lien, or granting other relief); Crocker Nat'l Bank v. American Mariner Indus. (*In re* American Mariner Indus. Inc.), 734 F.2d 426 (9th Cir. 1984) (creditor receiving benefit of its bargain by including "lost opportunity cost" within calculation of adequate protection promotes availability of affordable credit); *In re* All-Way Serv., Inc., 73 Bankr. 556, 565-76 (Bankr. E.D. Wis. 1987). The Supreme Court, however, has severely limited the utility of this approach to adequate protection. In a recent case the Court concluded that Congress did not intend to compensate undersecured creditors—those without an equity cushion—for the interim opportunity costs prior to plan confirmation. United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 404 U.S. 365 (1988); *accord In re* Briggs Transp. Co., 780 F.2d 1339 (8th Cir. 1985).

336. *See In re* Duncan, Fed. Bankr. L. Rep. (CCH) ¶ 67,001, at 67,724 (Bankr. E.D. Tenn. 1980) (Bare, B.J.) (reversing a setoff under 11 U.S.C. § 553 (1982)).

All-Brite Sign Services Co.,[337] the court held: ". . . setoff may be exercised if, and only to the extent that, funds from the deposited checks were finally collected at the time of bankruptcy."[338]

This case imposes still another complication on the setoff process. While in the past there was some certainty that a bank could set off against an uncollected balance and reverse upon any dishonor, there is now a well-reasoned case holding that setoff against uncollected funds may not be made at all. Furthermore, the case was based upon non-bankruptcy law, *i.e.*, on law providing that no mutual debtor-creditor relationship arises until the provisional credit turns into an absolute credit upon final payment of the item.[339]

All-Brite is persuasive precedent supporting the conclusion that no setoffs should be made on uncollected funds.[340] The rationale supporting *All-Brite* is as follows: the setoff reduces both the debt due the bank and the deposit due the depositor. If a credit for an uncollected item is included in the setoff, the debt due the bank is reduced, but there may be no real asset collected. For example, final repayment may never be made on the uncollected item. Relying on *All-Brite*, courts may hold that the reduction of the debt due the bank is irreversible even if the item is uncollected. In other words, it is possible that a court may say that the setoff was an irreversible election by the bank to reduce the loan balance and to risk the possibility that the provisional credit would be revoked.[341] Worse, it is possible to imagine arguments to the effect that the firming-up of provisional credits might constitute post-petition receipts which would be included in the debtor's estate under Bankruptcy Code section 541. If the item is dishonored, the bank could not increase the loan balance. *All-Brite* creates sufficient new risks. Uncollected funds should not be viewed as balances and should not be included in setoff unless a careful contemporaneous analysis supports a contrary conclusion.

As to determining the amount of the improvement in position, there is an inescapable element of roulette. This is true because the improvement is

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337. Citizens Fidelity Bank & Trust Co. v. All-Brite Sign Serv. Co., 11 Bankr. 409 (W.D. Ky. 1981).

338. *Id.* at 413.

339. The facts in *All-Brite* are as follows: On the day before bankruptcy, the debtor deposited $6,175 in checks. Having been found entitled (for reasons not relevant to this article) to receive relief from the automatic stay and to make a setoff, the bank wished to include in the amount set off the funds receivable by it on collection of such deposited checks. The court denied this request, holding instead that setoff requires a debtor-creditor relationship, *i.e.*, mutuality. *Id.* The court further held that the bank received the deposited checks as an agent for collection under U.C.C. § 4-201 and that the debtor-creditor relationship necessary as a precondition for setoff did not arise until the checks were collected.

340. As well reasoned as the *All-Brite* decision is, there is as yet little appellate authority to support its conclusion.

341. Would a setoff satisfy the value requirement for the bank to become a holder in due course? *See* U.C.C. §§ 3-302(1), 3-303(b), 4-208, 4-209.

measured, in part, by reference to the ninetieth day prior to the date the bankruptcy petition is filed. Unless the bank itself is planning to make an involuntary bankruptcy filing against the borrower, the bank will not know when, or if, a bankruptcy petition will be filed. Hence, estimates of the amount of improvement in position could be inaccurate to the extent that daily account balances or outstanding loans vary and to the extent that the estimate of the probable filing date used for purposes of determining the size of the improvement is wrong.

VII. Post-Bankruptcy Status of Loan Loss Reduction Options Not Utilized Before Bankruptcy

A. *Post-Bankruptcy Status of Financing Options*

The stage for this discussion is set by section 362 of the Bankruptcy Code. That section establishes a bright-line rule governing creditor behavior. Upon the filing of a bankruptcy petition, an *automatic* stay arises by operation of law, enjoining creditor actions to set off debts, perfect security interests, and foreclose on any property in which the bankruptcy estate has an interest.[342]

Once the section 362 stay goes into effect,[343] bank creditors are prohibited from utilizing any of their common law loan loss minimization devices without the express permission of the bankruptcy court.

First, a setoff which has not been consummated before the section 362

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342. In pertinent part 11 U.S.C. § 362 (1982 & Supp. IV 1986) (automatic stay) provides:
(a) . . . a petition filed under . . . this title . . . operates as a stay, applicable to all entities, of—

. . . .

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

. . . .

(b) The filing of a petition under . . . this title . . . does not operate as a stay—

. . . .

(3) under subsection (a) of this section, of any act to perfect an interest in property to the extent that the trustee's rights and powers are subject to such perfection under Section 546(b) of this title or to the extent that such act is accomplished within the period provided under Section 547(e)(2)(A) of this title . . . .

343. Although the section 362 stay enjoins the specified creditor behavior by operation of law upon the filing of a bankruptcy petition, experienced debtor's counsel will often seek and obtain bankruptcy court orders incorporating section 362's provisions (and at times necessary corollary orders under section 101's all writs provision) to serve on creditors giving them actual notice.

stay goes into effect may not be exercised. (As discussed above, the Bankruptcy Code compensates the creditor more or less adequately with an unconsummated pre-bankruptcy right of setoff.) No debit may be taken after the section 362 stay goes into effect. This leaves an unexercised debit especially vulnerable. When debit exists without a right of setoff, it is virtually worthless in terms of providing any advantage over general unsecured creditors.[344] As to perfection, no unauthorized act either to perfect a security interest or to foreclose on collateral is permitted except as provided in Bankruptcy Code sections 546(b) and 547(e)(2)(A),[345] neither of which appears to be applicable to common law perfection of security interests.

A creditor holding a right of unconsummated setoff enjoys a highly preferred status under the Bankruptcy Code. He is entitled to enforce this right before the credit subject to setoff can be used by the trustee for the benefit of the estate.[346] In addition, a creditor with an unconsummated setoff right is entitled to preferential treatment under the ultimate plan of liquidation or reorganization. Further, an unconsummated setoff is not subject to avoidance by the trustee on the ground that the creditor improved his position during the ninety-day period prior to bankruptcy. Thus, unconsummated setoff is in fact superior to consummated setoff, in terms of the value which the creditor receives.

Congress intended this result. Pre-bankruptcy setoffs are considered a significant proximate cause of many bankruptcy filings. When creditors (bank, trade, and others) become fearful of the possibility of bankruptcy and engage in the proverbial creditors' race to seize assets, their setoff action can so drain a debtor's cash flow as to trigger a bankruptcy. Such a race can start a chain reaction, the result of which is to leave protection under the

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344. Indeed, its only advantage may be that the bank gets the time-value of the money before the trustee gets the funds turned over.

345. 11 U.S.C. § 362(a)(4)(5), 362(b).

346. In pertinent part 11 U.S.C. § 363 (Supp. IV 1986) (use, sale, or lease of property) provides:

> (a) In this section, "cash collateral" means cash, negotiable instruments . . . *deposit accounts*, or other cash equivalents . . . whether existing before or after the commencement of a case under this title.
>
> . . . .
>
> (c)(2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless—
>
> (A) each entity that has an interest in such cash collateral consents; or
>
> (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with provisions of this section
>
> . . . .
>
> (e) Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used . . . or proposed to be used . . . by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide *adequate protection* of such interest . . . .

[Emphasis added].

bankruptcy laws as the only means to obtain relief. Congress was aware of this, and expressly provided incentives for creditors to refrain from exercising the right of setoff: "adequate protection" in bankruptcy and distributional preference upon plan confirmation. In addition, Congress provided disincentives in the form of the recapture provisions, for consummated setoffs and other pre-bankruptcy transfers based on antecedent debts.

Two questions: (1) Is adequate protection granted during bankruptcy to creditors which do not set off? (2) Is the relative priority of unconsummated setoff sufficient, especially in liquidation cases where super-priority claims may consume the debtor's assets? This second concern needs no further discussion beyond the observation that in bankruptcy certain claims, such as administrative expenses, professional fees, and the like, have a super-priority which can consume a substantial portion of the estate's value.[347]

Adequate protection is a topic which has been the subject of academic comment and case development.[348] Suffice it to say that "adequate protection" may not fully compensate a creditor in economic terms. To this extent the intended advantages of unconsummated setoff over consummated setoff may be somewhat or entirely negated, notwithstanding the recapture provisions associated with consummated setoff. A true comparison depends on analysis of the particular facts in light of the statutory incentives and disincentives associated with each device. Nevertheless, given the statutory incentives and disincentives, unconsummated setoff is the probable winner.

Aside from Bankruptcy Code section 547 recapture problems, perfection gives a creditor a preferred status resembling that created by unconsummated setoff. A perfected secured creditor is entitled to "adequate protection" in connection with the use of its collateral during a bankruptcy proceeding, especially in respect to "cash collateral." In addition, the perfected secured creditor is entitled to a priority upon distribution, but is still subject to the administrative and other super-priorities under the Bankruptcy Code. In summmary, a perfected secured party is substantially better off than a creditor who has not perfected its security interest prior to bankruptcy.

There are some pertinent limitations on the right to foreclosure which have the effect of freezing-in the assets of the estate subject to the estate's ability to provide adequate protection. An unperfected security interest gives its holder no protection upon the filing of a bankruptcy petition. This is so because upon the filing of the bankruptcy petition the bankruptcy trustee assumes the status of a judgment lien creditor who then has priority over an unperfected security interest under both state and federal law. The

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347. These expenses would not have priority over a section 506(a) secured claim, including an unconsummated setoff claim, in liquidation. Nevertheless, they may consume a debtor's assets prior to plan confirmation.

348. *See, e.g.*, Nimmer, *Secured Creditor and the Automatic Stay: Variable Bargain Models of Fairness*, 68 MINN. L. REV. 1 (1983).

consequence is that the unperfected secured party finds himself in the same "class" as general unsecured creditors.

B. *Partial Setoff v. Full Setoff*

A question suggested by the foregoing is: Are partial setoffs best? The wise course is for the bank: (1) to set off the non-recapturable balance and keep it; (2) to avoid setting off the portion representing the improvement in position; and (3) to receive a secured claim on the portion not set off. Where the improvement in position is large enough to make a post-petition section 553 recapture action likely, this procedure would be superior to full setoff because it combines the best of both worlds: immediate recovery of a portion of the funds and a secured claim for the balance.

This is, however, only one of the three scenarios which can result from partial setoffs. While this one is "the best of both worlds," the second possibility is essentially the same as full setoff and the third possibility produces a worse result. There is, therefore, an unquantifiable risk that partial setoffs will not produce the desired result.

The Bankruptcy Code apparently contemplates that either full setoff or no setoff will be made and that the bank deciding whether to set off has the choice of having either: (1) current use of the funds obtained by setoff, subject to being required to return any portion of the amount set off which represents an improvement in position, or (2) a secured claim on the full balance as an unconsummated setoff. Unfortunately, the statute gives little guidance as to how partial setoffs (*i.e.*, total balances minus improvements) would be treated and whether they are advisable.

The dual purposes of the statute—preventing improvements in position resulting from setoffs and encouraging workout—suggest a possibility of adverse allocation.

1. *Possibility of Adverse Allocation*

Because it appears to assume that setoff will be made on an "all or nothing" basis, the statute is drawn to allow the estate to recover any improvement in position during the ninety-day pre-filing period. This statutory formulation would permit a trustee to make the argument that, where a bank decides to make a partial setoff of collected balances minus improvements, account balances should be adversely allocated against the bank and in favor of the estate. Where there has been an improvement in position during the ninety days prior to bankruptcy and the bank has properly set off collected balances minus improvements, the court which decides to allocate the balances adversely would deem that the setoff was made first from the improvement and reverse that portion of the setoff under section 553, and then grant a secured claim, if any, only as to the portion of book balance which was not set off.

To illustrate, assume that ninety days before the filing of a bankruptcy petition there is a loan balance of $10 million and a deposit balance of $5 million. On the day before the petition is filed, the loan balance remains at $10 million, but the deposit balance has risen to $6 million. The facts thus create a $1 million improvement in position. Suppose next that there is a $5 million setoff. What are the rights of the parties? The bank would prefer to keep the full $5 million and have a $1 million secured claim for the balance not set off. If allocation were employed, however, $1 million of the setoff would be recaptured. The bank would end up with a $4 million recovery and possibly a $1 million secured claim.

On the one hand, since the Bankruptcy Code's main purpose is to deny the creditor a setoff of the improvements in position made during the ninety-day pre-filing period, and not to deny him what he would have been entitled to set off on the ninetieth day before bankruptcy, courts may not be willing to employ adverse allocation (*i.e.*, they may not permit the estate to recover any portion of the setoff where the setoff is limited to the pre-improvement balances). On the other hand, an estate might have a significant incentive to argue for adverse allocation, given an appropriate set of facts. There is some statutory support for this proposition since the statute says that setoff plus improvement in position equals recapture. Why should a partial setoff be immune from recapture if a full setoff would not be immune?

2. *Possibility of Secured Claim for Balances Not Set Off*

On the foregoing analysis, a partial setoff may be subject to recapture. The availability of secured status as to amounts not set off, once a partial setoff has been taken, is also problematic.

The creditor who refrains from setoff provides at least two benefits to the estate. He allows the debtor a chance to achieve an out-of-court "workout," and during the ninety-day period (and also during the proceeding if true adequate protection is provided) he affords the debtor use of the funds which would have been set off. One view of the policy reason for the secured creditor status given by Bankruptcy Code section 506 is that it rewards the creditor for foregoing setoff and compensates him for his loss of the use of the balances.

A creditor who takes a setoff, even if only of the "non-improvement" portion, denies the estate the benefits mentioned above. If the foregoing policy analysis is correct, then the *raison d'être* of the creditor's secured status is gone. It is possible that the courts will reach this conclusion and therefore deny secured status to the creditor who takes a partial setoff.

To illustrate the options, assume a stable loan of $100 million. Assume, first, that balances ninety days before filing are at $10 million and setoff date balances are at $60 million (*i.e.*, there has been a large improvement in position), and second, that balances ninety days before filing are at $50 million and setoff date balances are at $60 million (*i.e.*, there has been a small improvement). The improvements are $50 million under the first assumption and $10 million under the second assumption. The bank's objectives are, first, to maximize recovery; second, to maximize the amount of the secured claim; and third, to make the amount at risk as small as possible.

3. *Conclusion on Full v. Partial Setoff*

Partial setoff achieves the best result, but may be litigated and may ultimately be rejected by the courts. Partial setoff minimizes bank exposure, but is untested in the crucible of bankruptcy.

VIII. The Federal Tax Lien

The federal government, as tax collector, is likely to be one of the major creditors of a failing business. Tax liability for past income may not be assessed until years after the taxable event. Moreover, tax liability does not arise exclusively from taxable income. In fact, many failing businesses neglect those obligations to the federal government which arise from the various withholding taxes (including wage and social security taxes).[349] These taxes are costs of doing business and are incurred without regard to business profitability or income. As a result of unpaid tax obligations, the federal government can become a substantial creditor of a debtor business, competing with other creditors for scarce assets.[350]

Taxes are "the life blood of government."[351] The sovereign's access to that life blood has been protected through the Internal Revenue Code (hereinafter IRC), which gives the federal government a lien on "all property and rights to property, whether real or personal, belonging to" the taxpayer.[352] This statute serves the dual purpose of putting payment pressure on the delinquent taxpayer and preserving the government's priority as against other claimants to the taxpayer-debtor's assets.[353]

Priority between the federal tax lien and the interests in personalty created under state law is generally determined by the time when the IRS files notice of its tax lien.[354] The federal tax lien arises at the time of "assessment," a non-public administrative act.[355] Yet the lien is not valid against

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349. *Cf.* Texas Oil & Gas Corp. v. United States, 466 F.2d 1040, 1053-54 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973).

350. The federal government can also become a creditor as a result of claims arising out of breaches of contract, torts, and the like. Although some reference will be made below to the government in its capacity as a non-tax creditor, the essential focus in this article will be on the federal government as a tax creditor.

351. Bull v. United States, 295 U.S. 247, 259 (1935).

352. 26 U.S.C. § 6321 (1982).

353. Plumb, *The New Federal Tax Lien Law*, 22 Bus. Law. 271, 271-76 (1967).

354. *See* Duncan & Lyons, *Federal Tax Liens and the Secured Party*, 21 U.C.C. L.J. 3, 11 (1988).

355. 26 U.S.C. § 6322 (1982). *See* Coogan, *The Effect of the Federal Tax Lien Act of 1966*

any "purchaser, holder of a *security interest*, mechanic's lienor, or judgment lien creditor until notice thereof . . . has been filed" in a certain designated place or places.[356] And though the mechanics of filing such a tax lien notice are not free from complexity,[357] the statutory linchpin is the IRC's definition of a security interest. A security interest is defined as:

> any interest in property acquired by contract for the purpose of securing payment or performance of an obligation or indemnifying against loss or liability. A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth.[358]

Thus, the IRC provides that where a security interest is sufficiently "protected under state law" to withstand attack by a state judgment lien creditor, then the interest is also "protected" for the purposes of priority over the federal tax lien.[359]

Indeed, the Eleventh Circuit Court of Appeals resolved the issue of priority in just such a straightforward manner. In *Trust Co. v. United States*,[360] the court held that the only question to be decided was whether under local (Georgia) law the taxpayer had created a valid security interest in two general deposit accounts which were "protected under local law."[361] The security interest at issue was created when the taxpayer signed promissory notes which provided in pertinent part:

> The term "Collateral" . . . shall mean the following property which has been or is hereby delivered, pledged, assigned, conveyed and transferred to the holder . . . together with all other property of every kind and description including accounts, monies and deposits now or hereafter in possession or control of [the bank] . . . . The [debtor] agrees that [the bank] shall have a lien upon, security title to and a security interest in the Collateral to secure payment of this Note . . . . [362]

Upon Security Interests Created Under the Uniform Commercial Code, 81 HARV. L. REV. 1368, 1373 (1968).

356. 26 U.S.C. § 6323(a) (1982) (emphasis added).

357. In 1966 Congress enacted major modifications to the IRC with respect to the federal tax lien. Its principal intent was to bring the IRC more closely into conformity with state law and in particular the U.C.C.. Congress did not, however, simply incorporate by reference the provisions of the U.C.C.. Rather, Congress adopted its own modified version of some U.C.C. provisions given the different policy objectives of the tax law. *See* Young, *Priority of the Federal Tax Lien*, 34 U. CHI. L. REV. 723, 726-27 (1967).

358. 26 U.S.C. § 6323(h)(1) (1982).

359. *See, e.g.*, Aquilino v. United States, 363 U.S. 509 (1960); Donald v. Madison Indus., Inc., 483 F.2d 837 (10th Cir. 1973).

360. Trust Co. v. United States, 735 F.2d 447 (11th Cir. 1984).

361. *Id.* at 449.

362. *Id.* at 448.

The court concluded that this assignment was sufficient under local law for the bank to obtain a "preference to or lien on the account."[363]

Although this case is a useful beginning for analysis, *Trust Co.* does not provide sufficient facts or analysis of complex issues to provide the guidance necessary for evaluating the relative merits of the loan loss devices.[364] For example, the case does not discuss the extent of the property interest retained by the depositor in the assigned accounts. Nor does it discuss the degree of control actually exercised by the bank over the hypothecated accounts. Reference to other sources is necessary to more fully define the contours of the tax lien as it applies to common law loss minimization devices.

Numerous other cases have considered the question of the tax lien in competition with various bank interests in deposit accounts. A sampling of these cases is discussed.

Four such cases already referred to are *United States v. Harris*,[365] *Peoples National Bank v. United States*,[366] *United States v. Third National Bank*,[367] and *Jefferson Bank & Trust v. United States*.[368] *Harris* upheld a bank interest in a "Collateral Pledge Agreement" which apparently provided that the deposit accounts could be used to reduce any indebtedness due the bank. Significant to the issue of the bank's control over the accounts, the amounts in the deposit accounts varied throughout the loan period.[369] The court did not, however, focus on this. Rather, the court found the common law pledge sufficient and therefore the bank's lien "choate." The court did not determine the effect of the tax lien on the bank's right of unconsummated setoff.[370]

Harris advances the development of analytical tools only slightly. While the court's recognition of the possibility of common law pledge without an indispensable instrument was a step in the common law evolution of the principles articulated in *Duncan Box*, *Harris* did not consider how much control the bank must exercise over a deposit account in order to achieve common law perfection and priority over state judgment lien creditors.[371]

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363. *Id.* at 449.

364. The court does not directly address the question whether such a "preference" or "lien" is invulnerable to a state judgment lien creditor. The court does cite Macon Nat'l Bank v. Smith, 170 Ga. App. 1332, 153 S.E. 4 (1930), but that venerable pre-U.C.C. authority would hardly seem to be sufficient. Moreover, the court does not address the rather troublesome issue of Congress' apparent intent to provide protection under 26 U.S.C. § 6323(h)(1) (1982) only to those interests perfected under the U.C.C.. Hence, while the holding in *Trust Co.* is correct, the analysis is weak on troubling issues.

365. United States v. Harris, 249 F. Supp. 221 (W.D. La. 1966).

366. Peoples Nat'l Bank v. United States, 777 F.2d 459 (9th Cir. 1985).

367. United States v. Third Nat'l Bank, 589 F. Supp. 155 (M.D. Tenn. 1984).

368. Jefferson Bank & Trust Co. v. United States, 684 F. Supp. 1542 (D. Colo. 1988).

369. United States v. Harris, 249 F. Supp. at 224.

370. *Id.* at 223.

371. To the extent that the decision can be read to suggest that the provisions in the "Collateral Pledge Agreement" as reported were adequate to create a perfected common law

Despite its favorable holding, *Harris* is simply not persuasive precedent for the common law propositions advanced.

Peoples National Bank is more helpful in defining the contours of the requisite common law security interest. Recall that the court adhered to the notion that an indispensable instrument was necessary to effectuate a common law pledge of a deposit account. The court went on to discuss the requirements of common law assignment in a manner which was much like the Second Circuit Court of Appeals' discussion in *Wells Fargo*.[372] In *Peoples National Bank* the court noted that on the facts before it, there had been no transfer of title to the bank and no divesture of control over the account up to the time the bank had received actual notice of the federal tax lien.[373] Thus, *Peoples National Bank* can fairly be read to suggest that a *Duncan Box* assignment and divesture of control would satisfy the protection requirement under local law and, therefore, would have priority over a tax lien.

Significantly, the court reached the question of the bank's right of setoff when in competition with a tax lien. The court held that an unconsummated setoff was not sufficiently protected under local law to have priority over an attaching tax lien.[374]

The third case which bears on the relationship between common law perfection and the tax lien is *Third National Bank*.[375] In that case the facts did not demonstrate a sufficient assignment nor divestiture of control. Significantly, the court in dicta approved *Duncan Box* in principle with respect to both the formalities necessary to create an adequate common law assignment and pledge without an indispensable instrument, and the degree of control which must be exercised by the bank over the hypothecated deposit account. The court reached the issue of setoff and concluded that the bank's unconsummated setoff was *not* superior to the federal tax lien.[376]

Finally, in *Jefferson Bank & Trust*, the court held that an unconsummated setoff was not superior to a federal tax lien.[377] The court found that a security interest had been granted in a deposit account and that this interest was sufficiently choate to withstand the federal tax levy.[378] In that case there was evidence that the bank had exercised control over the fluctuating account and had monitored the account.

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security interest, the decision appears to be flawed. An agreement which grants a bank the right to apply whatever credit happens to exist at the time loan obligations become due, and does not divest the depositor of control over the account before that time, appears to be little more than a right to debit and as such, an unperfected security interest.

372. Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548 (2d Cir. 1976).

373. Peoples Nat'l Bank v. United States, 777 F.2d at 462.

374. *Id.*

375. United States v. Third Nat'l Bank, 589 F. Supp. 155 (M.D. Tenn. 1984).

376. *Id.* at 158.

377. Jefferson Bank & Trust Co. v. United States, 684 F. Supp. 1542 (D. Colo. 1988).

378. *Id.* at 1547.

A pattern can be discerned in these cases.[379] First, as a general proposition *Duncan Box* reserve accounts should withstand attack by tax authorities, provided they are technically adequate and control is in the bank.[380] On this question the federal courts will probably accept the local law as defined by the state courts with legitimate non-tax considerations in view. This does not, however, appear to be the case with respect to unconsummated setoff.

Thus far, federal courts have not been willing to treat unconsummated setoff as sufficiently protected under state law. While this antagonism to setoff has a long history under the "choateness" doctrine, it is not entirely consistent with developing state law, which is to the effect that a bank may exercise its right of setoff as against a judgment lien creditor even after the bank has received an order of attachment.[381] Thus, the tax lien law appears to be developing in a way which is somewhat anomalous and circular.[382]

IX. Evaluation of the Devices

As to ease of creation, setoff is best, debit is second, and perfected security interest is last. Setoff rights arise by operation of the common law and generally require little or no advanced planning, contractual agreement, or administrative expense to create. Debit requires some advanced planning at the time the loan agreement is entered into because of the pre-authorization requirement, but like setoff, debit requires little or no additional administrative expense to establish. Perfected security interest, by contrast, requires the most planning and administrative expense to create and maintain.

Under this criterion, therefore, setoff is the best bargain. Given its current status under state law and the bankruptcy law, common law setoff of-

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379. The federal tax lien as applied to the financing arrangements discussed in this article raises additional questions not thoroughly explored herein.

380. Another case not previously cited suggests in dicta that a reserve account similar to that used in *Duncan Box* would have had priority over a federal tax lien. *See* United States v. Carlow, 323 F. Supp. 1310, 1316 (W.D. Penn. 1971). In *Carlow* the court did not reach this question because the bank there ultimately recovered on all of the notes for which the reserve accounts were security. Thus even if the bank had been entitled to priority over the tax lien, it no longer was once its security interest had been terminated or extinguished due to full payment on the notes which the accounts collateralized.

381. *See, e.g.*, United States v. Sterling Nat'l Bank & Trust Co., 360 F. Supp. 917, 922 (S.D.N.Y. 1973).

382. There is a potential circularity problem if the bank's right of setoff has priority over a judgment lien creditor or garnishor, but not over the federal tax lien. For example, in United Seeds, Inc. v. Eagle Green Corp., 389 N.W.2d 571, 574-75 (Neb. 1986), the court concluded that a bank was estopped from asserting and waived its right of setoff where the bank, after making entries showing a setoff, allowed the depositor to overdraft its checking account. Although it was not clearly stated in the opinion, the conclusion that the bank could have effectuated its setoff rights after being served with the garnishment notice was implicit. In the actual case the bank's behavior after receipt of this notice was inequitable and therefore it lost or waived its rights.

fers relatively low cost protection to banks. It is suggested that common law setoff may be the most cost efficient method for using deposit accounts as collateral. Before the scope of protection offered by this common law device is altered, careful consideration should be given to the effect any such changes are likely to have on the cost of bank credit.

As to ease of use on short notice, technicalities in certain jurisdictions, such as New York, make debit preferable to setoff. Perfected security interest may be superior to both setoff and debit, because it is already in place before the triggering event (*i.e.*, the filing of a bankruptcy petition or the attachment of a tax lien) occurs, and thus split second action by the bank is not usually required to employ perfected security interest devices. Moreover, under the approach adopted by *Duncan Box*, common law perfected security interests may prove less vulnerable than setoff rights in contests with Article 9 perfected security interests.

While perfected security interest is superior under this criterion, it is not cost free. Substantial monitoring costs may be associated with maintaining a perfected security interest at a level adequate to collateralize a loan at the bargained-for level. Yet all three of the loss minimization devices require some monitoring if they are to be used effectively.

As to vulnerability to recapture if bankruptcy follows after the use of each device, whether non-preferential perfection or consummated setoff is better depends on the facts. For example, if there has been no "improvement in position," consummated setoff is nearly as good as non-preferential perfection. On some facts non-preferential perfection may be slightly inferior to consummated setoff, because while a non-preferential perfection should be invulnerable to avoidance by the trustee as a preference, problems of foreclosure may nevertheless involve the underlying collateral in the bankruptcy proceeding. If there has been an improvement in the bank's position, non-preferential perfection is by definition less vulnerable than consummated setoff. Debit and voidable perfection are both highly vulnerable.

With respect to the second consideration—entanglement in the bankruptcy proceeding as property of the estate—depending on the facts and on developments in the law concerning the scope of the property interests included within a bankruptcy debtor's estate, non-preferential perfection may be only slightly inferior to consummated setoff. A consummated setoff which cannot be attacked as a preference should avoid most of the problems associated with inclusion in the bankruptcy estate. This question is far more open with respect to non-preferential perfection. Yet even assuming *arguendo* that a non-preferential perfection is included with the estate, the bank would be entitled to considerable protection under the Bankruptcy Code's provisions relating to the use of cash collateral. Thus, non-preferential perfection should rank close to consummated setoff. By contrast, debit and voidable perfection are both highly vulnerable to post-petition attack.

As to benefits which will follow in bankruptcy if the loss minimization device is not used, unconsummated setoff is preferable to consummated setoff. Indeed, given the low vulnerability of unconsummated setoff to post-petition preference attack, it is superior to all other devices with respect to transfers made on the eve of bankruptcy. Debit and voidable perfection confer few benefits or none.

On the whole, reliance on setoff rights is usually the bank's best recourse. In most situations there is little reason to go to the extra effort and expense of setting up a perfected security interest. But if the bank is concerned that the technicalities alluded to above (for instance, lack of mutuality and possibly lack of maturity, if the *Manville* definition of "claim" is not applied in this context) may defeat the right of setoff or that bankruptcy may come as a surprise, non-preferential perfection may be best because it does not require quick action prior to the bankruptcy. It is already in place *and* it offers most of the advantages of unconsummated setoff.

Setoff and debit are currently the most frequently used common law methods of using deposit balances to reduce loan losses. As suggested above, they are often confused in the cases and commentary, largely because they are similar in implementation and they are often used in conjunction. The differences between them, while subtle, can be critical in bankruptcy. Debits are considered "transfers" under the Bankruptcy Code. Therefore they are potentially subject to complete recapture as voidable preferences under Bankruptcy Code section 547. By contrast, consummated setoffs are not considered "transfers" and are not subject to recapture under section 547. Consummated setoffs are, however, potentially reversible under Bankruptcy Code section 553, not as section 547 preferences, but to the extent of improvement in position during the ninety days before bankruptcy. This distinction as to the controlling statutory provision can make a substantial difference, usually in favor of unconsummated setoff, since only improvements in position can be recaptured under section 553. More important, unconsummated setoff is not subject to post-bankruptcy recaptures and is accorded protection during bankruptcy proceedings and priority upon distribution.

Non-preferential perfection, which has many advantages over debit and some advantages over consummated and unconsummated setoff, is almost never used except in connection with the pledge of "indispensable instruments." This is so because it has been widely thought that creation and perfection of a security interest in a deposit account is not achievable under the existing common law.

One method of creating such an interest, innovatively approved in *Duncan Box*,[383] is to set up a "reserve account" over which the depositor has no right of control or present title and with respect to which the bank issues no misleading documentary proof of unencumbered ownership. Another

383. Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140, 142 (W. Va. 1980).

method is to use the funds in the deposit to buy an instrument from the bank, such as a certificate of deposit or a certified or official bank check. Possession of such an "indispensable instrument" by the bank would perfect the security interest under the pledge provisions of U.C.C. Article 9.[384] The major disadvantages of perfected security interests are the higher transaction costs associated with creating and maintaining them. Despite these higher transaction costs, perfection deserves more careful consideration than it has received in structuring transactions to reduce bank risk.

The relative usefulness of these common law devices depends on the event which is expected to follow the use of the device. If bankruptcy is not expected, the choice of method should be controlled largely by ease of creation and implementation. A small chance of bankruptcy is insufficient to justify the higher transaction costs entailed in using a perfected security interest. From this point of view, consummated setoff and debit, in that order, are usually the preferable methods. This is so because no pre-default authorization from the depositor is normally needed in consummated setoff, while it is required in debit. Both forms of perfected security interest are undesirable, because both require substantially more documentation to create and are more cumbersome to implement and maintain.

A related consideration is the extent to which the option selected by the bank can affect its position in negotiations with other creditors during a possible work-out or other pre-bankruptcy-petition creditor negotiation.[385] In many cases a borrower in financial difficulty can rearrange its financial affairs without a formal bankruptcy proceeding. In the context of such a negotiated rearrangement, creditors may voluntarily agree to a reorganization of the debtor's affairs; but they do so with knowledge of their respective recapture rights and priorities in bankruptcy. Thus, for example, a non-preferential perfection might offer certain negotiating advantages over all of the other options, because creditors know that if the negotiation fails and bankruptcy follows, non-preferential perfection is among the most preferred post-bankruptcy devices.

This advantage may be justified by the bank's role in monitoring the debtor's behavior and bringing the risk of default and bankruptcy to the attention of other creditors. This supposition should be subject to careful study. Nevertheless, early warnings from banks may help all creditors since voluntary rearrangements appear to be cheaper than bankruptcy proceedings.[386] Another problem is that both consummated setoff and debit require

384. U.C.C. § 9-304.

385. *See, e.g.*, Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 867-68 (1982).

386. While they are less costly, work-outs do not have the advantage of ensuring fairness and equity in treatment among the various creditors. Court supervised reorganizations are probably better at protecting these objectives. Work-outs may nevertheless be more cost effective.

careful timing to ensure that they are completed before they are enjoined by the automatic stay of section 362 of the Bankruptcy Code. If debit is not timely completed before bankruptcy, the bank will have less protection than if it had used non-preferential perfection or unconsummated setoff.[387] As between voidable perfection and unconsummated setoff, the bank's rights are better protected after bankruptcy by unconsummated setoff because setoffs have preferred recovery status under the Bankruptcy Code.

Further, unless there have been certain improvements in position during the ninety days preceding bankruptcy, non-preferential perfection in a stable deposit balance is immune from the post-bankruptcy recapture risks to which consummated setoff, voidable perfection and debit are exposed under sections 553 and 547 of the Bankruptcy Code.[388] There are, however, greater recapture risks for non-preferential perfection in a fluctuating deposit account. In addition, non-preferential perfection automatically enjoys the substantial post-bankruptcy benefits of "adequate protection" accorded to cash collateral under Bankruptcy Code section 363.

Significantly, only perfected security interests and consummated setoffs should be immune from the tax lien. Both unconsummated setoff and debit are subordinate to a federal tax lien. Thus, in any case where there is a significant risk that federal taxes may not be remitted on a timely basis by a debtor, perfected security interests offer a considerable advantage over even unconsummated setoffs.

Perfected security interests have additional advantages vis-a-vis the federal tax lien. In competition with the federal tax lien, the right of unconsummated setoff is virtually worthless. By contrast, perfected security interests have priority over the tax lien. Indeed, some of the cases suggest that the degree of perfection necessary to satisfy the "protected under state law" standard under the IRC may be less than the stringent assignment and transfer of control illustrated by the *Duncan Box* reserve account.

This article has attempted to expand the immediately available horizons of deposit account financing by exposing its fuller possibilities under the common law. It is to be hoped that scholars, practitioners and courts will take up where this article leaves off and reaffirm the continuing viability of the common law to accommodate changing financing needs. Codification may be an efficient route to change, but it is not the only route.[389] In the interim, notwithstanding the U.C.C.'s exclusion of deposit account financing,

387. Unconsummated setoff may not be available because one or more of the setoff requirements, such as mutuality, may not be met.

388. Strictly speaking, by definition non-preferential perfection should not include choses in action which arise during the preference period. From a practical perspective, however, some improvement in position, or voidable transfer, may occur in such accounts. Thus, many accounts may have both forms of perfected security interests—a fact which raises potential allocation problems.

389. *Cf.* Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205, 206 (1982). *But see generally* M. HOROWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860 (1977).

greater clarity in the common law of hypothecated deposit accounts should lead to greater utilization of these financing options and a system of law that more fully honors and protects the bargains between banks and their customers.[390]

390. *See* 1 GILMORE, *supra* note 4, § 10.7, at 315.