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THE PROBLEMS WITH SETOFF: A PROPOSED LEGISLATIVE SOLUTION

STEPHEN L. SEPINUCK*

ABSTRACT

This Article explores the current status of the law of setoff in this country. It first briefly examines the history of setoff, details where and when it arises, and explains its importance. The Article then illustrates the different ways in which states have approached some of the complex issues presented by setoff and determines which approaches appear best. Finally, presuming the need for increased uniformity, the Article proposes a draft Uniform Setoff Act and an "Official Comment" thereto.

INTRODUCTION

The Origins of Setoff

In its most basic form, setoff is the cancellation of cross demands, that is, the satisfaction of all or part of a debt owed by X to Y through the simultaneous discharge or forgiveness of a debt due to X from Y. Setoff began in ancient Rome with the doctrine of *compensatio*.¹ During the time of Gaius, setoff was limited to certain claims arising out of the same contract and its use remained a matter of judicial discretion.² Under Marcus Aurelius and Justinian, the doctrine was expanded to include claims arising

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1. Loyd, *The Development of Set-Off*, 64 U. PA. L. REV. 541, 541 (1916). Although published more than seventy years ago, this article remains the most thorough and carefully researched treatise on the history of the setoff doctrine.

2. Comment, *Automatic Extinction of Cross-Demands: Compensation from Rome to California*, 53 CALIF. L. REV. 224, 229-30 (1965).

from different transactions and was extended to reach both real and personal actions.³

Eventually, the doctrine made its way to France, where it can be traced to the fourteenth century. In England, however, the doctrine generated less enthusiasm. Under the English legal system, the forms of action and the system of pleadings were designed to bring opposing parties to a single issue, affirmed on one side and denied on the other. Interjection of a collateral issue or claim ran counter to this basic philosophy and must have seemed intolerable.⁴ Nevertheless, some early courts of chancery, exercising equitable jurisdiction and conscious of the unfairness of denying setoff against parties with few or dwindling financial resources, found a basis for setoff outside the formalities of law. They also recognized its concomitant benefit of avoiding circuitry and multiplicity of suits.⁵

In 1705, the doctrine finally received legislative support through a temporary bankruptcy statute.⁶ It reemerged in 1729, as part of an act reforming debtors' prisons and insolvency proceedings. This time the doctrine had a much broader application, extending beyond insolvency proceedings and applying generally:

[w]here there are mutual Debts between the Plaintiff and Defendant, . . . one Debt may be set against the other, and such Matter may be given in Evidence upon the General Issue, or pleaded in Bar, as the Nature of the Case shall require, so as at the Time of his pleading the General Issue, where any such Debt of the Plaintiff . . . is intended to be insisted on in Evidence, Notice shall be given of the particular Sum or Debt so intended to be insisted on, and upon what Account it became due.⁷

3. Loyd, *supra* note 1, at 541-42; Comment, *supra* note 2, at 231, 234. At this early age, at least one modern question originated: are mutual claims extinguished automatically as a matter of law, or is some further action, such as an agreement between the parties or a judicial decree, necessary to effect the result? Loyd, *supra* note 1, at 542-43; see *infra* note 33 and accompanying text.

4. Loyd, *supra* note 1, at 543-44.

5. Morton, *Creditor Setoffs in Business Reorganization and Relief Cases Under the Bankruptcy Act*, 50 AM. BANKR. L.J. 373, 374 (1976).

6. 4 Anne, ch. 17, § 11 (1705) (providing that the creditors of a bankrupt who owe him a debt would not be compelled to pay more than the balance due after adjusting the account).

7. 2 Geo. 2, ch. 22, § 13 (1729).

The term "mutual debts" suggested to some that this provision was restricted to claims arising from the same transaction. Yet, when this act was made perpetual in 1735, an

Throughout the eighteenth and nineteenth centuries, however, set-off was available only in judicial proceedings and remained subject to all the formalities of English law.⁸

Surprisingly, setoff on this side of the Atlantic predates the English statutes. As early as 1645, the colony of Virginia permitted civil defendants to set off debts due to and debts owing from a plaintiff. By 1654, Maryland had followed with a similar measure for discounting debts. In 1682, Pennsylvania added its own version, one somewhat more comprehensive than the subsequent English legislation. Moreover, as reenacted shortly after the turn of the eighteenth century, the Pennsylvania statute permitted a defendant to obtain affirmative relief if, after setoff, he remained a creditor of the plaintiff.⁹

New York adopted its own statute in 1714, largely identical to the Pennsylvania act, but requiring that written notice of the offsetting debt be given with the responsive plea.¹⁰ In 1722, New Jersey enacted its version, closely tracking the New York statute, but also requiring that the defendant plead his setoff "or else forever after be barred of bringing any action for that which he might or ought to have pleaded by virtue of this act."¹¹ Although certain formalities remained for some time,¹² these acts evidently evolved

amendment providing that mutual debts could be set off notwithstanding that they were deemed "to be of a different nature" removed this ambiguity. 8 Geo. 2, ch. 24, § 5 (1735).

8. See *Stooke v. Taylor*, 5 Q.B.D. 569, 575 (1880). There, the court said:

By the Statutes of Set off this plea is available only where the claims on both sides are in respect of liquidated debts, or money demands which can be readily and without difficulty ascertained. The plea can only be used in the way of defense to the plaintiff's action, as a shield, not as a sword. Though the defendant succeeded in proving a debt exceeding the plaintiff's demand, he was not entitled to recover the excess; the effect was only to defeat the plaintiff's action, the same as though the debt proved had been equal to the amount of the claim established by the plaintiff, and no more.

9. See *Loyd*, *supra* note 1, at 557.

10. See *id.* at 558 n.75.

11. See *id.* at 560.

12. In addition to being generally restricted to liquidated claims, setoff also was apparently restricted to contract and debt obligations. A defendant could raise tort claims (other than through a separate suit) only under the doctrine of recoupment, which developed later. The doctrine foreclosed affirmative relief and was limited to loss or damage arising from the same transaction as the plaintiff's claim. See *id.* at 562-63, and cases cited therein; see also *Brown v. Patterson*, 214 Ala. 351, 108 So. 16 (1926); *Bates v. Lanier*, 75 Fla. 79, 77 So. 628 (1918).

into the permissive and compulsory counterclaims present in modern American pleading systems.

Setoff thus began as an innovative pleading tool. Yet, with the advent of the liberal pleading rules embodied in the Federal Rules of Civil Procedure, much of the original purpose and early complexities of setoff have vanished. Still, the spirit and substance of setoff lives on, now outside the courtroom and the narrow confines of pleading formalities. Setoff has become a widely recognized area of substantive law.

The Current Uses of Setoff

Although the precise actions necessary to effect setoff are unclear, setoff can now certainly be effected without judicial involvement.¹³ The circumstances under which privately effected setoff may arise are quite varied. For example, merchants occasionally set off the account debts generated when they buy from and sell to each other.¹⁴ More frequently, banks will use account deposits to set off overdue loans made to their depositors.¹⁵ In fact, in reliance

13. For sample legislative authority, see 26 U.S.C. § 6402(a) (1982 & Supp. IV 1986); U.C.C. § 4-303 (1978) (implying a bank right that may be exercised unilaterally). For cases involving setoff prior to litigation, see *Pittsburgh Nat'l Bank v. United States*, 657 F.2d 36 (3d Cir. 1981) (based on Pennsylvania law); *Baker v. National City Bank*, 511 F.2d 1016 (6th Cir. 1975) (based on Ohio law); *In re Saugus Gen. Hosp.*, 7 Bankr. 347 (Bankr. D. Mass. 1980), *rev'd on other grounds*, 698 F.2d 42 (1st Cir. 1983) (based on Massachusetts law). These cases discuss the action necessary to accomplish setoff. Nonjudicial setoff is not a recent phenomenon; it dates back many decades. See *First Nat'l Bank v. Coplen*, 39 Cal. App. 619, 179 P. 708 (1919). Indeed, early cases held that the failure to timely effect setoff could discharge a guarantor. See, e.g., *Tatum v. Commercial Bank & Trust Co.*, 193 Ala. 120, 69 So. 508 (1915). But see Mitchell, *The Negative Pledge Clause and the Classification of Financial Devices*, 60 AM. BANKR. L.J. 153, 167 (1986) (commenting that debts between nonbanks cannot be set off without judicial action or mutual consent in most jurisdictions).

14. See, e.g., *Sterling Nat'l Bank & Trust Co. v. Southwire Co.*, 713 F.2d 684 (11th Cir. 1983) (setoff attempted between copper dealer and copper scrap dealer).

15. Funds deposited in a general checking or savings account become property of the bank, and the depositor becomes merely a creditor of the bank for the amount in the account. *Crocker-Citizens Nat'l Bank v. Control Metals Corp.*, 566 F.2d 631, 637 (9th Cir. 1977) (based on California law); *United States v. Citizens & S. Nat'l Bank*, 538 F.2d 1101, 1103-05 (5th Cir. 1976), *cert. denied*, 430 U.S. 945 (1977) (based on Georgia law); *Jensen v. State Bank*, 518 F.2d 1, 5 (8th Cir. 1975) (based on Iowa law); *In re Comprop Inv. Properties, Ltd.*, 81 Bankr. 101, 103 (Bankr. M.D. Fla. 1987) (based on Florida law); *In re Saugus Gen. Hosp.*, 7 Bankr. at 350 (based on Massachusetts law); *Fleischmann v. Mercantile Trust Co.*, 617 S.W.2d 73, 74 (Mo. 1981); *In re Elsinore Shore Assocs.*, 67 Bankr. 926, 936 (Bankr. D.N.J. 1986) (based on New Jersey law); *Industrial Comm'r v. Five Corners Tavern, Inc.* 47

upon their ability to effect setoff swiftly, banks occasionally require borrowers of large sums to maintain their deposit accounts with the lending institution.¹⁶

Even when setoff arises during litigation, courts no longer treat it as a procedural device but instead recognize it as a substantive right.¹⁷ The exact nature and scope of this right is varied and unclear. Yet, setoff undeniably affects the priority of creditors and, therefore, remains a significant concern in structuring commercial transactions.

The Importance of Setoff

The importance of setoff perhaps is best demonstrated when one party to a pair of mutual debts becomes bankrupt or insolvent. In such a case, when a debtor lacks the ability to fully satisfy his debt, setoff becomes more than a mere alternative to bringing suit to enforce an obligation. It frequently becomes the only means by which a creditor can fully collect.

The general scheme of modern bankruptcy law requires that the bankruptcy trustee or debtor-in-possession¹⁸ marshal all of the bankrupt's unencumbered assets before distributing assets to creditors with unsecured claims. This action includes collecting debts owed to the bankrupt. In a reorganization proceeding, these assets then are used by the debtor-in-possession to generate additional assets for later distribution to creditors. In a liquidation, the trustee sells the assets and distributes the proceeds to creditors in

N.Y.2d 639, 645 n.2, 393 N.E.2d 1005, 1007 n.2, 419 N.Y.S.2d 931, 934 n.2 (1979); *Sears v. Continental Bank & Trust Co.*, 562 S.W.2d 843, 844 (Tex. 1977).

If the bank also has an outstanding loan to the depositor, the paradigm of the joint creditor/debtor relationship necessary for setoff exists. Presumably because joint creditor/debtor status is created most readily in this setting, bank setoff comprises more than half of the setoff litigation.

16. See the security arrangements in *In re Multiponics, Inc.*, 622 F.2d 725 (5th Cir. 1980); *Glenn Justice Mortgage Co. v. First Nat'l Bank*, 592 F.2d 567 (10th Cir. 1979).

17. This is particularly evident when setoff is claimed in total or partial defense to a writ of garnishment. In most jurisdictions, the substantive right of setoff defeats the rights of a garnishor. See *infra* note 101 and accompanying text. Many states also have statutes creating various substantive setoff rights. *E.g.*, S.D. CODIFIED LAWS ANN. § 44-11-11 (1983) (providing banks with a general lien upon deposits).

18. "Debtor-in-possession" is a term of art, defined in 11 U.S.C § 1101(1) (1982) to include almost every debtor in a reorganization proceeding. A debtor-in-possession generally has all the powers of a trustee in a liquidation proceeding. *Id.* § 1107(a).

what is supposed to be a more expedited fashion. In both cases, creditors are divided into classes and arranged in a hierarchy specified by statute.¹⁹ The equitable distribution that the Bankruptcy Code then seeks to effect requires that no creditor in a class receive a greater percentage of his claim than any other creditor in the same or higher class.

In theory, therefore, one who is both a creditor and a debtor of the bankrupt will be compelled to pay his debt in full, and then receive payment with his class on what is likely to be only a small percentage of his claim. Setoff permits a creditor to avoid this basic scheme of the Bankruptcy Code by netting out his claim and his debt.²⁰

Not surprisingly, several courts have noted that the availability of setoff seems to run counter to the fundamental policy underlying bankruptcy law: a fair and proportionate distribution to creditors.²¹ For this reason, some courts have prohibited its exercise

19. See *id.* §§ 507, 510, 1122.

20. *Id.* §§ 542(b), 553; see also *id.* §§ 741(6), 751, 752(a) (providing for distribution of net claims to the customers of bankrupt stockbrokers).

Setoff not only permits a creditor to recover effectively a greater portion of his claim, but to recover it in a much more timely fashion. Although the automatic bankruptcy stay prevents creditors from effecting setoff after the bankruptcy petition is filed, *id.* § 362(a)(7), a creditor "with a right to setoff is entitled to relief from the stay, unless [his] interest is adequately protected." *In re Dartmouth House Nursing Home, Inc.*, 24 Bankr. 256, 265 (Bankr. D. Mass. 1982). Moreover, unless subject to a preference attack under § 553(b), discussed *infra* note 25, setoff effected prior to the filing of the bankruptcy petition is not subject to the stay provisions. *E.g.*, *In re Jefferson Mortgage Co.*, 25 Bankr. 963, 971 (Bankr. D.N.J. 1982); *In re Compton Corp.*, 22 Bankr. 276, 277-78 (Bankr. N.D. Tex. 1982); *In re Donato*, 17 Bankr. 708, 709 (Bankr. E.D. Va. 1982).

21. See *Baker v. Gold Seal Liquors, Inc.*, 417 U.S. 467, 473-74 (1974) (acknowledging that setoff during bankruptcy is a form of priority that prefers some creditors over others and is thus contrary to bankruptcy policy); see also H.R. REP. NO. 595, 95th Cong., 1st Sess. 185 (1977) ("Setoff is an interruption in the conduct of business, and may have detrimental effects on the attempted reorganization"); Note, *Inequality or Equality Among Creditors? The Second Circuit Preserves the Right of Setoff: In re Applied Logic Corp.*, 11 CONN. L. REV. 601, 605 (1979) (suggesting that prior to the Bankruptcy Reform Act of 1978, a trend towards restricting setoff rights was developing in the courts).

This Article takes no position on whether setoff should remain available in bankruptcy proceedings (or generally exempt from attack as a preference, see *infra* note 25). The expansive scope of setoff adopted by the legislation proposed at the end of this Article need not require expansive application in bankruptcy. If such a change in bankruptcy policy were desirable, the Bankruptcy Code could be modified easily to restrict or abolish setoff. This result would appear preferable to modifying the legislation proposed here, which has wide application and use outside of the area of bankruptcy.

against a debtor undergoing a bankruptcy reorganization.²² Nevertheless, because setoff is firmly grounded in fundamental notions of fairness, it has been incorporated in every United States bankruptcy statute.²³ Most courts now permit setoff absent "compelling circumstances,"²⁴ and treat it essentially as a security interest, rather than as the equitable remedy of its origin.²⁵ Accordingly, a creditor owing a mutual debt available for setoff is entitled to adequate protection of his claim or relief from the automatic stay.²⁶

22. *E.g.*, *In re Utica Floor Maintenance, Inc.*, 31 Bankr. 509, 512 (Bankr. N.D.N.Y. 1983). There, the court stated:

[t]o remove further working capital from the Debtor at this time by way of setoff would result in jeopardizing the Debtor's prospects for a successful reorganization. It would deprive the Debtor of the protection of Chapter 11 when it needs it most. To permit setoff would be inconsistent with Chapter 11 of the Bankruptcy Code and not in the best interest of any of the creditors.

23. Comment, *Bank Insolvency and Depositor Setoff*, 51 U. CHI. L. REV. 188, 192 & nn.23-24 (1984).

24. *E.g.*, *In re Inslaw, Inc.*, 81 Bankr. 169, 170 (Bankr. D.D.C. 1987); *In re Springfield Casket Co.*, 21 Bankr. 223, 228 (Bankr. S.D. Ohio 1982); *In re Allbrand Appliance & Television Co.*, 16 Bankr. 10, 14-15 (Bankr. S.D.N.Y. 1980).

25. 11 U.S.C. § 506(a) (1982) ("An allowed claim of a creditor . . . that is subject to setoff under section 553 of this title, is a secured claim . . . to the extent of the amount subject to setoff"); see also *In re Compton Corp.*, 22 Bankr. 276, 277 (Bankr. N.D. Tex. 1982) ("The Bankruptcy Reform Act carries into current practice the prevailing pre-Code concept of viewing a setoff claim as a form of security interest"); Freeman, *Setoff Under the New Bankruptcy Code: The Effect on Bankers*, 97 BANKING L.J. 484, 486, 519-22 (1980); Comment, *Setoff in Bankruptcy: Is the Creditor Preferred or Secured?*, 50 U. COLO. L. REV. 511, 526 (1979).

The Code's policy against preferences also illustrates this point. To effectuate the bankruptcy purpose of equitable distribution, the bankruptcy trustee or debtor-in-possession is empowered to rescind almost any transaction made within the 90 days preceding the bankruptcy filing that has the effect of preferring one creditor over others in the same or higher class. 11 U.S.C. § 547 (1982 & Supp. IV 1986). To this end, a transfer or perfection of a security interest can be an avoidable preference. See *id.* § 101(48) (defining transfer). A transfer in satisfaction of a valid security interest, however, perfected more than 90 days before the filing, generally will not constitute an avoidable preference. Setoff rights are treated similarly. If a creditor incurs a debt to the bankrupt within the 90 day period so that setoff can extinguish the creditor's claim against the bankruptcy estate, setoff will be denied. *Id.* § 553(a)(3). Moreover, setoff effected within the 90 days preceding the filing may be partially or totally avoided if the creditor's debt to the bankrupt was increased during that time. *Id.* § 553(b). Yet, the exercise of setoff to satisfy a claim with a debt incurred more than 90 days before the bankruptcy filing will not be subject to a preference attack.

26. *E.g.*, *In re Williams*, 61 Bankr. 567, 571 n.5 (Bankr. N.D. Tex. 1986); *In re Dartmouth House Nursing Home, Inc.*, 24 Bankr. at 265; *In re Gazelle, Inc.*, 17 Bankr. 617, 620 (Bankr. W.D. Wis. 1982). Cf. 2 COLLIER ON BANKRUPTCY ¶ 361.01 (15th ed. 1987) (adequate protection extends generally only to that portion of a creditor's claim that is secured).

Moreover, setoff apparently remains available to satisfy creditors' claims that would otherwise be subordinated,²⁷ and as a procedural matter, the right to setoff does not depend on the timely filing of a proof of claim.²⁸

Even outside the bankruptcy context, setoff remains an extraordinarily fast and inexpensive means of debt collection. In addition, its availability can provide a unique alternative to traditional forms of security, as well as a means of reducing the judiciary's ever-increasing backlog. Setoff is thus a valuable commercial tool—a tool which should be standardized to avoid frustrating the reasonable expectations of those who deal in the fast-paced, modern world of interstate commerce.

The Basic Problem

Despite the breadth of its application, or perhaps because of it, the law of setoff is fraught with variations from jurisdiction to jurisdiction. Both the Bankruptcy Code and the Uniform Commercial Code reference setoff rights expressly,²⁹ yet neither defines nor describes these rights. Both defer to applicable state law, which varies widely in procedure, availability, and effect. Moreover, as will be demonstrated, the treatment of setoff under these two codes is inharmonious. Modern bankruptcy law effectively gives setoff the status of a perfected security interest. As generally interpreted, the Uniform Commercial Code does not.

This jurisdictional variation and statutory discord forms the main concern of this Article. Modern commercial transactions increasingly cross state boundaries, yet still require speed in their consummation and certainty in the availability, method, and extent of enforcement. Differences in state commercial law under-

27. *In re Sound Emporium, Inc.*, 48 Bankr. 1, 2-3 (Bankr. W.D. Tex. 1984); accord *In re De Feo Fruit Co.*, 24 Bankr. 220, 226 (Bankr. W.D. Mo. 1982).

28. Setoff may be effected prior to discharge of the bankrupt even though no proof of claim was filed before the court-ordered deadline. *In re G.S. Omni Corp.*, 835 F.2d 1317 (10th Cir. 1987) (per curiam); *In re Sutton Invs., Inc.*, 53 Bankr. 226, 230 (Bankr. W.D. La. 1985); see also *In re Monex Corp.*, 43 Bankr. 879, 886 (Bankr. S.D. Fla. 1984) (setoff alleged in adversary proceeding sufficient as a proof of claim). But cf. *In re Britton*, 83 Bankr. 914, 920-21 (Bankr. E.D.N.C. 1988) (creditor waived setoff rights by filing proof of claim without asserting such rights).

29. 11 U.S.C. § 553 (1982 & Supp. IV 1986); U.C.C. §§ 4-303, 9-104(i), 9-306(4)(d) (1978).

mine this certainty. General application of such legislation as the Uniform Commercial Code and the Uniform Partnership and Limited Partnership Acts³⁰ leaves the law of setoff as one of the last and most important sources of this troublesome variation.

PROCEDURAL DIFFERENCES AND INADEQUACIES

State Law

No state statute or provision of the Uniform Commercial Code specifies what acts a creditor must take to exercise setoff rights. In fact, the only aid the authors of the Uniform Commercial Code provide is in the form of an almost humorous tautology: "In the case of setoff the effective time is when the setoff is actually made."³¹

Judicial decisions have provided some help, requiring in most states some overt or positive act to effect setoff.³² Yet, even this rule is not universal. Pennsylvania apparently adheres to an old common-law rule providing for the automatic extinction of matured mutual debts.³³ By operation of law and without any act by either party, such debts are set off against each other as soon as the latter of the two matures.

Even in jurisdictions that require some conduct to effect setoff courts have not specified what conduct will suffice. Indeed, when presented with a dispute as to whether certain actions constitute setoff, courts have rarely used the opportunity to provide any general guidelines.³⁴ The one exception is the United States Court of

30. Other legislation contributing toward a single body of commercial law throughout the Nation includes the Uniform Consumer Credit Code, the Uniform Consumer Sales Practices Act, the Uniform Fraudulent Conveyances Act, the Uniform Motor Vehicle Certificate of Title and Anti-theft Act, and federal laws, such as the Consumer Credit Protection Act, 15 U.S.C. §§ 1601-1693 (1982 & Supp. IV 1986), the Magnuson-Moss Warranty Act, 15 U.S.C. §§ 2301-2312 (1982), and the corresponding regulations.

31. U.C.C. § 4-303 comment 5 (1978). In fairness to the drafters of the U.C.C., some courts have found this comment useful. See cases cited *infra* notes 32-36.

32. *E.g.*, *United States v. Citizens & S. Nat'l Bank*, 538 F.2d 1101, 1106-07 (5th Cir. 1976), *cert. denied*, 430 U.S. 945 (1977); *Jefferson Bank & Trust Co. v. United States*, 684 F. Supp. 1542 (D. Colo. 1988); *In re McCormick*, 5 Bankr. 726, 730 (Bankr. N.D. Ohio 1980).

33. *Pittsburgh Nat'l Bank v. United States*, 657 F.2d 36, 38 (3d Cir. 1981).

34. *E.g.*, *In re Elsinore Shore Assocs.*, 67 Bankr. 926, 945 (Bankr. D.N.J. 1986) ("Under New Jersey case law, the charging or debiting of a debtor's funds on deposit by a creditor

Appeals for the Sixth Circuit, which established the following rule in 1975: "setoff is not complete until three steps have been taken: (1) the decision to exercise the right, (2) some action which accomplishes the setoff and (3) some record which evidences that the right of setoff has been exercised."³⁵

Although several other courts have followed this rule,³⁶ it provides little guidance. Step two is so vague that almost any conduct might reasonably be considered sufficient. Step three apparently requires an appropriate bookkeeping entry, but that too is uncertain. Aside from rejecting the automatic extinction of mutual debts present in Pennsylvania, this rule simply parallels the conclusory statement found in the comment to the Uniform Commercial Code.

This lack of clarity presents at least three problems. First, in the abstract, if the procedures necessary to effect setoff are uncertain, creditors may inadvertently waive their setoff rights.³⁷ Alternatively, creditors may simply refrain from exercising setoff for fear of doing it incorrectly. For instance, a tenant who has lent money to her landlord may not wish to attempt to set her rent obligation off against the loan debt for fear of defaulting on her lease. Any mortgagor, or other person whose contract requires periodic payments and includes nonpayment as a default from which acceleration or foreclosure could result, might be similarly disinclined to risk setoff unless the necessary procedures are clear.

bank has been recognized as constituting a setoff"); *In re Saugus Gen. Hosp.*, 7 Bankr. 347, 352 (Bankr. D. Mass. 1980), *rev'd on other grounds*, 698 F.2d 42 (1st Cir. 1983) (setoff effective when bank issued treasury checks to itself and depositor could no longer draw on funds rather than when bookkeeping entry later made). In neither case did the court address what lesser action, if any, will suffice.

35. *Baker v. National City Bank*, 511 F.2d 1016, 1018 (6th Cir. 1975).

36. See *In re McCormick*, 5 Bankr. 726, 730 (Bankr. N.D. Ohio 1980); *United Seeds, Inc. v. Eagle Green Corp.*, 223 Neb. 360, 363, 389 N.W.2d 571, 574 (1986).

37. In reality, waiver is based normally on the failure to timely claim setoff rights during some judicial proceeding. See *In re Metropolitan Int'l, Inc.*, 616 F.2d 83 (3d Cir. 1980) (also holding that waiver must be intentional). Yet, a bank may also waive its setoff rights by entering into a workout agreement with a depositor and the creditors of that depositor. *In re Applied Logic Corp.*, 576 F.2d 952 (2d Cir. 1978); *First Nat'l Bank v. Dudley*, 231 F.2d 396 (9th Cir. 1956); see also *Walters v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 59 P.2d 983 (Cal. 1936), *modified*, 9 Cal. 2d 46, 69 P.2d 839 (1937) (setoff rights waived as against garnishor). The likelihood of waiver in general or under the particular facts of these cases if setoff were effected automatically when mutual debts matured, as in Pennsylvania, remains in question.

Second, creditors and courts must know the effective moment of setoff to determine when interest on the extinguished debts stops running and to calculate preference attacks under section 553(b) of the Bankruptcy Code and fraudulent transfers under companion section 548.³⁸ Third, creditors must know what procedures constitute setoff to determine what actions remain permissible once subject to the automatic bankruptcy stay. Lack of certainty on this issue has been the source of much litigation.

Bankruptcy Stay Litigation

Section 362(a) of the Bankruptcy Code³⁹ prohibits generally all action against the debtor and the bankruptcy estate when a bankruptcy petition is filed. This prohibition expressly extends to the exercise of setoff rights.⁴⁰ Violations of the stay subject the offending party to liability for compensatory damages, attorneys' fees,

38. 11 U.S.C. §§ 548, 553 (1982 & Supp. IV 1986); *see also id.* § 547. These sections affect the validity of prior transactions. They also measure time from the moment the bankruptcy petition was filed to the instant the questioned transaction was performed. Courts and creditors must therefore know precisely when the questioned transaction occurred to determine its validity.

39. *Id.* § 362.

40. *Id.* § 362(a)(7). Section 362(a) provides:

Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, . . . operates as a stay, applicable to all entities, of -

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(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

and, in appropriate circumstances, punitive damages.⁴¹ Accordingly, creditors must know what acts constitute setoff so that they can protect themselves without violating the stay.⁴²

The primary and most frequent question posed in this context is whether a bank owed money by a bankrupt depositor may "freeze" the assets remaining in the bankrupt's deposit account. Although the issue is frequently raised, courts have not given it consistent treatment.

Most courts analyzing this issue have determined that freezing a debtor's account does not amount to a setoff and therefore does not violate the stay.⁴³ The grounds for such decisions have varied. Some courts have looked to the three-step test established by the Sixth Circuit and concluded that the necessary action or intent was not present.⁴⁴ Other courts have found support in the Bankruptcy Code. Some of these courts concluded that because the deposits are cash collateral that the trustee or debtor-in-possession cannot use without a notice and a hearing,⁴⁵ a freeze merely preserves the status quo and effectuates the statutory scheme which Congress created.⁴⁶ Several other courts have relied on section 542(b) of the Bankruptcy Code, which requires each entity owing a matured debt to the bankruptcy estate to pay such debt to the

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

See *id.* § 362(b)(6)-(7) for exceptions relevant to setoff rights.

41. *Id.* § 362(h).

42. See *Cusanno v. Fidelity Bank*, 29 Bankr. 810, 812 (E.D. Pa. 1983) (suggesting that an administrative hold on bank deposits would violate § 362(a)(3) even if it did not constitute a setoff stayed by § 362(a)(7)).

43. See cases cited *infra* notes 44, 46, 47; see also *In re Raanes*, 17 Bankr. 164, 166 (Bankr. D.S.D. 1982) ("The philosophy for staying a bank's right of setoff is to facilitate a debtor's reorganization efforts. When a debtor is in a liquidation, there is no reason for staying a post-filing setoff"); cf. *In re Rinehart*, 76 Bankr. 746, 755-56 (Bankr. D.S.D. 1987) (distinguished from an administrative freeze because a check was actually drawn on the debtor's account).

44. *In re Davis*, 29 Bankr. 652, 654 (Bankr. W.D.N.Y. 1983).

45. 11 U.S.C. § 363 (1982 & Supp. IV 1986).

46. *In re Lee*, 40 Bankr. 123, 125 (Bankr. E.D. Mich. 1984); *In re Owens-Peterson*, 39 Bankr. 186, 189 (Bankr. N.D. Ga. 1984); *In re Gazelle, Inc.*, 17 Bankr. 617, 620 (Bankr. W.D. Wis. 1982); *Kenney's Franchise Corp. v. Central Fidelity Bank*, 22 Bankr. 747, 749 (W.D. Va. 1982); see also *Rio v. Army Aviation Center Fed. Credit Union*, 82 Bankr. 139 (M.D. Ala. 1986) (discussing but not clearly basing its decision on § 363).

trustee or debtor-in-possession "except to the extent that such debt may be offset under section 553."⁴⁷

Although a single, consistent rationale might be intellectually pleasing, in resolving the issue, these courts have at least reached for the most practical result. After all, "[i]f banks are unable to follow such a procedure, they either must make frantic ex parte applications to the bankruptcy courts for relief from the stay or sit by and watch debtors dissipate funds subject to setoff rights recognized in § 553."⁴⁸ In part for this reason, at least one early commentator on the Bankruptcy Code expressly recommended freezing deposit accounts subject to setoff rights.⁴⁹

Nevertheless, several courts have held that retention of the bankrupt's funds without prior court approval violates the stay.⁵⁰ Only one of these cases expressly considered section 542(b), which appears to be determinative of the issue,⁵¹ and most were based on Pennsylvania law and its automatic setoff rule.⁵² Nevertheless,

47. *In re Edgins*, 36 Bankr. 480, 483 (Bankr. 9th Cir. 1984); *In re Air Atlanta, Inc.*, 74 Bankr. 426, 427 (Bankr. N.D. Ga.), *aff'd*, 81 Bankr. 724 (N.D. Ga. 1987); *In re Williams*, 61 Bankr. 567, 573-74 (Bankr. N.D. Tex. 1986); *In re Hoffman*, 51 Bankr. 42, 46 (Bankr. W.D. Ark. 1985); *In re Stann*, 39 Bankr. 246, 248 (D. Kan. 1984); *Kenney's Franchise Corp.*, 22 Bankr. at 748; *In re Carpenter*, 14 Bankr. 405, 407 (Bankr. M.D. Tenn. 1981); 11 U.S.C. § 542(b) (1982); *see also* cases cited *supra* note 15 (suggesting that deposit accounts merely create a debt from the bank to the depositor).

48. *In re Carpenter*, 14 Bankr. at 407; *see also In re Crispell*, 73 Bankr. 375, 379-80 (Bankr. E.D. Mo. 1987) (putting 7 day limit of freeze within which the bank must either release the frozen funds to the trustee or petition the court for permission to exercise setoff).

49. Freeman, *supra* note 25, at 510 (at least with respect to liquidations and involuntarily filed reorganizations); *see also* 4 COLLIER ON BANKRUPTCY ¶ 553.15[6] (15th ed. 1987) ("freeze should not be considered a violation of the stay"); Ahart, *Bank Setoff Under the Bankruptcy Reform Act of 1978*, 53 AM. BANKR. L.J. 205, 214 (1979) ("There is no rationale for staying bank setoff in a chapter 7 liquidation case . . .").

50. *United States v. Reynolds*, 764 F.2d 1004 (4th Cir. 1985); *United States v. Norton*, 717 F.2d 767 (3d Cir. 1983); *In re Rinehart*, 76 Bankr. 746 (Bankr. D.S.D. 1987); *In re Wildcat Constr. Co.*, 57 Bankr. 981 (Bankr. D. Vt. 1986); *Cusanno v. Fidelity Bank*, 29 Bankr. 810 (E.D. Pa. 1983); *In re LHG Resources, Inc.*, 34 Bankr. 202 (Bankr. W.D. Tex. 1983); *In re Executive Assocs., Inc.*, 24 Bankr. 171 (Bankr. S.D. Tex. 1982); *In re Mealey*, 16 Bankr. 800 (Bankr. E.D. Pa. 1982).

51. *In re Wildcat Constr. Co.*, 57 Bankr. at 985-86.

52. *E.g.*, *Norton*, 717 F.2d at 772; *In re Mealey*, 16 Bankr. at 802 (citing a lower court decision in *Norton* that also looked to Pennsylvania law). The bankruptcy court decision in *Cusanno*, unlike the district court decision on appeal, was based expressly on Pennsylvania law. *In re Cusanno*, 17 Bankr. 879, 882 (Bankr. E.D. Pa. 1982).

The remaining cases generally followed this Pennsylvania-based precedent. *United States v. Reynolds*, 764 F.2d at 1006-07 (following *Norton*); *In re LHG Resources, Inc.* 34 Bankr. at

they all essentially concluded that a freeze on assets was itself an effective exercise of setoff. This analysis was improper. Although state law is properly considered in determining the availability of setoff, nothing in section 553 or in the legislative history of the Bankruptcy Code suggests that the propriety of freezing a debtor's bank account should depend on differing state law classifications of the same conduct.⁵³

Yet, the problems with state setoff procedures are not limited to jurisdictional variations and the impact of such variations on what are supposed to be uniform bankruptcy laws.⁵⁴ The procedures are also almost universally defective in another respect: they fail to require notice to the other party.

The Need for Notice

This Article favors the expansive use of setoff. Nevertheless, one must recognize that setoff is an extremely powerful tool—a tool, which even if exercised properly, may injure the other party. The best example of this tendency is in a bank's use of setoff against a depositor.

When a bank sets off funds in a depositor's checking account against a debt owed it by that depositor, the bank is likely to dishonor any outstanding checks drawn on that account. If the debtor is a merchant, such dishonor may cause suppliers to cease delivering goods necessary to the depositor's business or may cause utility companies to discontinue essential services.⁵⁵ Requiring prior no-

203 (following *In re Executive Assocs.*); *In re Executive Assocs., Inc.*, 24 Bankr. at 172 (following *Cusanno*). Recent authority, however, has held that Pennsylvania's automatic setoff rule is inapplicable to setoffs in bankruptcy. See *infra* note 53 and accompanying text.

53. Groschald, "Freezing" the Debtor's Bank Account: A Violation of the Automatic Stay?, 57 AM. BANKR. L.J. 75, 81 (1983). See also *In re Northwest Elec. Co.*, 81 Bankr. 392, 395 (Bankr. W.D. Pa. 1988) ("we think it clear that [the automatic setoff rule] was not contemplated by the draftsmen of § 553, and that there must be an overt act by the creditor prior to bankruptcy in order to invoke the provisions of § 553(b)").

54. See U.S. CONST. art I, § 8 (providing that Congress shall have power to establish "uniform laws on the subject of bankruptcies throughout the United States").

55. *E.g.*, *Calmenson Clothing Co. v. First Nat'l Bank & Trust Co.*, 63 S.D. 338, 258 N.W. 555 (1935) (payees of dishonored checks were wholesale merchants; evidence showed injury to depositor's credit among these wholesalers); see also *Fleischmann v. Mercantile Trust Co.*, 617 S.W.2d 73 (Mo. 1981) (setoff and resulting dishonor allegedly caused damage to relationship with creditors); *Keller v. Commercial Credit Co.*, 149 Or. 372, 40 P.2d 1018 (1935) (failure to honor checks and other wrongful acts allegedly caused depositor to lose

tice of setoff might eliminate these effects, but it would also drastically impair setoff rights. Not only would depositors rush to withdraw their deposits after receiving notice, but setoff simply would cease to be the swift remedy that it is today. Banks would no longer be able to respond instantly to a bad situation. Lacking this power, they may be less reticent to call in a depositor's loan, thereby accelerating a different kind of injury to the depositor.

Requiring the bank to give contemporaneous notice of its action to the depositor cannot eliminate injury. Yet, such notice might reduce the amount of injury while costing the bank (or other party effecting setoff) little or nothing in money, time, and effort. Presumably for this reason, at least one state has statutorily required banks and savings and loan associations to notify depositors of setoff within one day following its exercise.⁵⁶ Moreover, article 9 of the Uniform Commercial Code requires notice in an analogous situation.

Upon default under a security agreement, the creditor is authorized to repossess the collateral. He may even do so without judicial process if such can be done without breaching the peace.⁵⁷ After repossession, or merely after default if perfection was through possession, as with an instrument or chattel paper,⁵⁸ the creditor may sell the collateral by private or public sale. However, the creditor must first give "reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made."⁵⁹ This notification requirement is designed so that the debtor and any other "persons entitled to receive it will have sufficient time to

several business contracts); *Harper v. First State Bank*, 3 S.W.2d 552 (Tex. Civ. App. 1928) (dishonor of checks resulting from setoff allegedly destroyed depositor's business); *Bernardini v. Central Nat'l Bank*, 223 Va. 519, 290 S.E.2d 863 (1982) (setoff resulted in dishonor of 27 checks).

56. CAL. FIN. CODE §§ 864, 6660 (West Supp. 1988).

57. U.C.C. § 9-503 (1978).

58. *Id.* §§ 9-304, 9-305.

59. *Id.* § 9-504(3). Notice is not required if the collateral "is perishable or threatens to decline speedily in value." This concern is not present in setoff, however, because liquidated debts are the only "collateral."

take appropriate steps to protect their interests."⁶⁰ The debtor cannot waive this notice prior to default.⁶¹

Admittedly, the analogy is not a perfect one. In the context of article 9, the protection accorded by notification usually consists of the opportunity to monitor the intended sale. It thus enables the debtor to reduce the risk of injury resulting from the creditor's misconduct through, for example, a collusive or commercially unreasonable sale of the collateral.⁶² The benefit accorded by contemporaneous notice of setoff is more in the nature of protecting the depositor from inadvertently injuring himself through the drawing of additional checks likely to be dishonored.⁶³ Yet this distinction seems largely irrelevant. Contemporaneous notice of setoff requires minimal effort, can produce no harm, and may actually serve a useful purpose. Consequently, states have been delinquent in not requiring such notice.⁶⁴

A requirement of contemporaneous notice has a concomitant benefit. It provides a standard action necessary to effect setoff and therefore provides a focus for analyzing preferences and fraudulent transfers. If a transfer were potentially voidable, one need measure only the time from the notice to the bankruptcy filing to determine its validity. Indeed, because the notice itself can serve as the one act necessary to effect setoff, it becomes setoff.⁶⁵ A mere freeze on a depositor's bank account will therefore not constitute setoff and will not violate the stay.⁶⁶

60. *Id.* § 9-504 comment 5.

61. *Id.* § 9-504(3).

62. *Cf. id.* § 9-507 (governing a secured creditor's liability for failing to give proper notice). Notification also helps to effectuate U.C.C. § 9-506, giving debtors a right of redemption prior to sale.

63. Presumably because such inadvertent injury is less likely to result when obligors on pledged accounts are instructed to direct their payments to the secured creditor, no notification to the debtor of such instructions is required. *See id.* § 9-502.

64. *Cf. Friendship Auto Sales, Inc. v. Bank of Willamette Valley*, 300 Or. 522, 716 P.2d 715 (1986) (setoff treated as conversion for failure to give notice required under agreement).

65. *Cf. Boyle v. American Sec. Bank*, 531 A.2d 1258 (D.C. 1987) (contemporaneous notice of setoff manifested election to accelerate note).

66. *See* 11 U.S.C. § 362(a)(7) (1982). As noted above, however, § 542(b) already seems to resolve this problem.

SUBSTANTIVE CONFUSION

Debt Status Needed for Setoff

No court or legislature has systematically laid down the elements necessary for setoff rights to accrue or described the scope of the setoff rights that have accrued. Even when one can glean general rules from judicial decisions, such rules are neither followed universally nor based on any coherent policy. Nevertheless, some of the basic requirements of setoff seem to command fairly widespread agreement.

For example, most courts deny a person owed an unmatured debt the unfettered ability to collect that debt through the exercise of setoff.⁶⁷ This seems reasonable. Such an ability would undermine the contractual relationship between the parties which rendered the debt unmatured in the first place.

Courts generally recognize an exception to this rule if the person against whom setoff is effected is insolvent.⁶⁸ This exception also makes sense. If setoff were not permitted in such circumstances, the solvent party might never collect the debt owed him but would still have to pay the debt he owes. This unfair result is precisely what underlies the existence of setoff rights in bankruptcy.⁶⁹

Contingent debts also have received fairly consistent treatment. Courts generally prohibit setoff when the debt owed to the person effecting it is contingent on some event which has not yet occurred

67. See *Crocker-Citizens Nat'l Bank v. Control Metals Corp.*, 566 F.2d 631, 637 (9th Cir. 1977); *United States ex rel. Crow Creek Sioux Tribe v. Tri-County Bank*, 415 F. Supp. 858, 869-70 (D.S.D. 1976); *Johnson v. Dutch Mill Dairy, Inc.*, 237 Minn. 117, 122, 54 N.W.2d 1, 4 (1952); *Marine Midland Bank v. Graybar Elec. Co.*, 41 N.Y.2d 703, 708, 363 N.E.2d 1139, 1142-43, 395 N.Y.S.2d 403, 407 (1977); *Zion's Sav. Bank & Trust Co. v. Rouse*, 86 Utah 574, 578, 47 P.2d 617, 619 (1935); see also Clark, *Bank Exercise of Setoff: Avoiding the Pitfalls*, 98 BANKING L.J. 196, 206 (1981); Freeman, *supra* note 25, at 492. But see *Bee Jay's Truck Stop, Inc. v. Department of Revenue*, 86 Ill. App. 3d 7, 13, 407 N.E.2d 755, 760 (1980) (garnishee could set off amount owing against a note not yet due); Comment, *Bankruptcy: Mutuality as a Requirement for Set-off*, 28 CALIF. L. REV. 606, 609 & n.17 (1940).

68. E.g., *Glenn Justice Mortgage Co. v. First Nat'l Bank*, 592 F.2d 567, 572 n.5 (10th Cir. 1979); *Jensen v. State Bank*, 518 F.2d 1, 5 (8th Cir. 1975); cf. *Walter v. National City Bank*, 42 Ohio St. 2d 524, 527-28, 330 N.E.2d 425, 428 (1975) (insolvency exception inapplicable if insolvency preceded creation of the debt to be set off). Even without this exception, insolvency often constitutes contractual grounds for accelerating a debt to maturity. See Clark, *supra* note 67, at 207.

69. See *supra* text accompanying notes 20-28.

or on some action which has not yet been performed.⁷⁰ Although these courts have failed to express the reason for this rule, the rationale seems to be the same as that for requiring a debt to be matured: if available, unilateral exercise of setoff would enable the obligee to bypass the contractual obligation that renders the debt to him not yet due.

Courts have not yet determined whether insolvency also operates as an exception to this rule, rendering contingent debts available for setoff. Yet, unlike unmatured debts, contingent debts do not necessarily become due in time. The mere fact of insolvency, therefore, would seem insufficient to warrant accrual of setoff rights.⁷¹ Moreover, a contingent debt might have a true value unrelated to the face amount of the obligation and highly dependent on the likelihood of the contingency.⁷² Even if setoff were permitted, it might be appropriate or even necessary to reduce the amount of the contingent debt which could be applied in offset, discharging the remainder.⁷³

General agreement also exists on another requirement. The debt owed to the person effecting setoff must be a liquidated one.⁷⁴ Again, courts have not explained the reason for this rule, but that reason is not difficult to deduce. If a debt remains unliquidated, a claim based on a tortious injury, for example, the debtor

70. *Walker v. Carolina Mills Lumber Co.*, 429 So. 2d 1065, 1069-70 (Ala. App. 1983) (setoff denied when contingency existed, proper once debt became fixed); *Johnson v. Dutch Mill Dairy, Inc.*, 237 Minn. at 122, 54 N.W.2d at 4.

71. *Cf.* Comment, *supra* note 67, at 610 (suggesting that if the contingency is that the debtor is only secondarily liable, and the creditor is required first to exercise his rights and exhaust his remedies against the primary obligor(s), insolvency of the primary obligor(s) should empower the creditor to exercise setoff against the debtor).

72. An unmatured debt's value is unlikely to be affected significantly by the lack of maturity itself, provided adequate interest is charged. Of course, as with the value of any debt, the value of an unmatured debt may depend significantly on the financial status of the obligor.

73. Once a bankruptcy petition has been filed, a contingent debt owed by the bankrupt can form the basis for an allowable claim. 11 U.S.C. § 101(4)(A) (1982) (defining "claim"). The bankruptcy court must estimate the value of the claim, essentially removing the contingency and fixing the debt owed by the bankrupt. *Id.* § 502(c). Under this process, setoff rights would accrue and could be invoked properly.

74. *Kress v. Central Trust Co.*, 153 Misc. 397, 398, 275 N.Y.S. 14, 16 (1934); *Freeman, supra* note 25, at 492; *TeSelle, Banker's Right of Setoff - Banker Beware*, 34 OKLA. L. REV. 41, 50-51 (1981); *cf.* Comment, *supra* note 67, at 609 & n.18 (suggesting unliquidated debts may be set off).

(tortfeasor) normally may not unilaterally determine the proper debt owed by the creditor (victim). A different rule does not and should not apply merely because the creditor happens to owe the debtor on some other obligation, however related. Accordingly, set-off of an unliquidated debt would be inappropriate if binding on the other party.

If setoff were not binding, then it would serve little or no purpose. If the parties cannot agree on a settlement and thereby liquidate the debt themselves, a judicial determination will be necessary. Nonbinding setoff would not remove the need for that determination. At best, it would provide a delay before recourse to the courts became necessary. In return, it would increase the issues requiring judicial scrutiny and time. These problems are precisely what setoff is designed to reduce. Hence, setoff is restricted generally to liquidated debts.⁷⁵

The last debt attribute necessary for setoff rights to accrue is mutuality. Mutuality is universally required, but it is rarely understood and often improperly applied. It is a source of interminable confusion, faulty analysis, and unjust results. Perhaps most important, the mishandling of mutuality has frustrated commercial expectations, not merely in those disputes battled out in court, but in those that were not litigated because of the existence of bad precedent.

In spite of this history, mutuality is not difficult to understand. For debts to be mutual, they must be between the same parties, and must be owing to and due in the same capacities.⁷⁶ In other words, for setoff to be proper, the party to whom each debt is owed must be the party on whom the other debt obligation falls. Moreover, each party must be acting in the same legal capacity on both debts. If John, in his individual capacity, owes a debt to Mary, and

75. As with contingent claims, a bankruptcy court can liquidate an unliquidated claim through the estimation process. *See supra* note 73.

76. *In re Fluhum Constr. Corp.*, 23 Bankr. 147, 152 (Bankr. M.D. Tenn. 1982); *see also* *Mercantile Trust Co. v. Mosby*, 623 S.W.2d 22, 24 (Mo. Ct. App. 1981) ("to warrant a setoff, the demands must be mutual and subsisting between the same parties and must be due in the same capacity or right") (quoting *Dalton v. Sturdivant Bank*, 230 Mo. App. 800, 76 S.W.2d 425 (1934)); *Nichols v. Metropolitan Life Ins. Co.*, 137 Ohio St. 542, 545, 31 N.E.2d 224, 225 (1941) ("mutuality of parties is an essential condition of a valid set-off That is, the debts must be to and from the same persons and in the same capacity").

John, as trustee for someone else, is owed a debt from Mary, mutuality is lacking. If Mary were permitted to set the two debts off, the trust would have lost an asset without having one of its liabilities discharged. If John were to set the debts off, the trust would be similarly drained (although it might have a claim against John for breach of his fiduciary obligations).

This simple and obvious principle first encounters difficulty when more than one obligee or obligor exists on one of the two debts. Prior to the time when state law was found to control in federal diversity actions, *Gray v. Rollo*⁷⁷ laid the rule down for federal courts. Pursuant to this decision, a debt owed by joint obligors could be set off against a debt owing to one of them, but a debt owing to joint obligees could not be set off against a debt owed by only one of them. The apparent rationale for this distinction rested in the potential prejudice to the co-obligee who is not party to the setoff. Setting off the debt of two joint obligors against a debt owed to one of them could not possibly prejudice the rights of the co-obligor. At worst, setoff might require the obligor who was party to the setoff to claim rights of contribution against his co-obligor.⁷⁸ On the other hand, using a debt owed to joint obligees to set off a debt owed by one of them gives that obligee a disproportionate benefit of the jointly owned debt account, unfairly prejudicing the co-obligee.

This reasoning makes good sense as far as it goes. Yet the distinction is subject to question when analyzed through its most common example: bank use of funds in a joint account to set off a debt owed to the bank by one of the joint accountholders. In such a case, each depositor has the power to collect the debt owed to them jointly. The depositor whose debt is discharged or reduced through setoff simply could have withdrawn funds from the account and used them to satisfy or reduce his debt.⁷⁹ The co-owner of the account would still lose account funds, but would have no

77. 85 U.S. (18 Wall.) 629 (1873).

78. This result does imply that the debt was jointly and severally owed. Otherwise, no single obligor could be required, either directly or through setoff, to pay more than his proportionate share. See Comment, *supra* note 67, at 612-13.

79. Largely for this reason, the Supreme Court ruled that the IRS may levy on a joint bank account even though only one of the joint depositors owes a tax deficiency. *United States v. National Bank of Commerce*, 472 U.S. 713 (1985). For the due process implications

cause to attack the transfer. Characterizing the same transfer as improper merely because it is effected by the bank seems strange.

On the other hand, subjecting joint depositors to the consequences of each other's actions after they have consented to share the same account seems more appropriate than subjecting them to the whim of a third party, such as a bank. Moreover, outside of the context of joint bank accounts, the distinction between setoff rules for co-obligors and co-obligees is based on good policy, and something is gained by having a clear, concise rule.

Unfortunately, state courts have neither accepted this distinction nor thoroughly analyzed the issue. Instead, they have adopted a variety of different and contradictory rules. Some courts entirely disallow setoff of joint account deposits to satisfy an individual debt unless the deposit contract expressly provides otherwise.⁸⁰ Others permit it only to the extent deposits by the debtor can be traced into the account.⁸¹ Still others permit it entirely.⁸²

State courts have also departed from each other with regard to jointly owed debts. Some permit setoff;⁸³ others do not.⁸⁴ If these jurisdictional differences were the only problems created by the mutuality requirement, the issue here might properly be relegated to a single footnote. In trying to do equity with special bank deposits, however, courts have confounded matters to a much greater degree.

Exactly what constitutes a special deposit is unclear. Perhaps such deposits can be described best by their principal effect: general deposits may be used to set off a debt owed by the bank's depositor, while special deposits are immune from this action. Of

of this rule, see Note, *Levying on Joint Bank Accounts: A Ticking Bomb for the Nondelinquent Joint Account Holder*, 70 MINN. L. REV. 1308 (1986).

80. Cf. *Chickerno v. Society Nat'l Bank*, 58 Ohio St. 2d 315, 390 N.E.2d 1183 (1979); *Nichols v. Metropolitan Life Ins. Co.*, 137 Ohio St. 542, 31 N.E.2d 224 (1941).

81. *In re Davis*, 29 Bankr. 652, 654 (W.D.N.Y. 1983); *Peoples Bank v. Turner*, 169 Md. 430, 182 A. 314 (1936); *Fleming v. Bank of Va.*, 231 Va. 299, 343 S.E.2d 341 (1986).

82. *Burgess v. First Nat'l Bank*, 31 Colo. App. 67, 497 P.2d 1035 (1972).

83. *Rush v. Citizens' Nat'l Bank*, 114 Ark. 170, 169 S.W. 777 (1914); *Sears v. Continental Bank & Trust Co.*, 553 S.W.2d 394 (Tex. Civ. App.), *rev'd on other grounds*, 562 S.W.2d 843 (Tex. 1977); see also *TeSelle*, *supra* note 74, at 52-53.

84. *Teeters v. City Nat'l Bank*, 214 Ind. 498, 14 N.E.2d 1004 (1938); *Harrison v. Harrison*, 118 Ind. 179, 20 N.E. 746 (1889); *Moore v. Greenville Banking & Trust Co.*, 173 N.C. 180, 91 S.E. 793 (1917).

course, merely describing deposits in this manner does not help differentiate between those that are available for setoff and those that are not.

The basic nature of special deposits is that they belong to someone else; their equitable ownership is held by someone other than the depositor. Because the depositor is not the true owner, mutuality is lacking and setoff would be improper. Putting it another way, some courts have noted that special deposits are less like a debt and more like a trust or bailment. The normal debtor/creditor relationship between a bank and its depositor⁸⁵ does not arise and the bank acquires no title to the funds. The beneficial owner retains title.⁸⁶

This analysis is technically wrong. Title to the funds does and should pass to the bank.⁸⁷ Ownership of the bank's concomitant debt on the account, however, does not belong to the depositor. It

85. See *supra* note 15.

86. *First City Nat'l Bank v. Long-Lewis Hardware Co.*, 363 So. 2d 770, 772 (Ala. 1978); *Coyle v. Pan Am. Bank*, 377 So. 2d 213, 216 (Fla. Dist. Ct. App. 1979); *Bernardini v. Central Nat'l Bank*, 223 Va. 519, 521, 290 S.E.2d 863, 864 (1982).

87. If a bank became insolvent and insufficient assets and insurance existed to fully reimburse all depositors, neither the titular owner nor the beneficial owner of the account would have any special claim on any remaining bank assets. Unless they have setoff rights against the insolvent bank, see Comment, *supra* note 23, the titular and beneficial owners would have to share proportionally with all other depositors who became creditors of the bank. *But cf.* *Hopper v. New Jersey Title Guar. & Trust Co.*, 127 N.J. Eq. 1, 11 A.2d 60 (1940) (ruling that special deposits are recoverable from the remaining funds of an insolvent bank before general depositors get their pro rata share, but ultimately resting decision on the true trust established by delivery of collateral to bank with instructions to sell it and hold the proceeds); see also *Tompkins v. Bender*, 42 F. Supp. 211 (M.D. Pa. 1941) (beneficial owners of property or funds held in trust by an insolvent bank are entitled to recover such assets in full); *Borough of Deal v. Asbury Park & Ocean Grove Bank*, 118 N.J. Eq. 297, 178 A. 790 (1935) (deposits in Borough's "Coupon Account" intended to satisfy bond interest obligations were special deposits; Borough had claim to remaining assets of insolvent bank over general depositors).

On the other hand, if a bank agrees to function as trustee under an express written trust, no debtor/creditor relationship need be created. For example, the bank might merely invest the trust *res* in stocks or bonds, in which case the bank will never have functioned in a capacity as either a debtor or creditor of the trust, and the trust beneficiaries would have priority in such stocks or bonds over creditors of the bank. Once a deposit account is established, however, a debtor/creditor relationship necessarily follows. The bank must become a debtor of the depositor. If the bank in its capacity as trustee opened the deposit account, the bank as trustee becomes a creditor of the bank in its capacity as a bank. *Cf.* *Kaufman v. First Nat'l Bank*, 493 F.2d 1070, 1072 (5th Cir. 1974) ("if a trustee deposits trust funds in his name as such, the deposit is general and a debtor-creditor relationship is created").

is beneficially owned by someone else. Yet, this analytical error does not appear too significant, as setoff is improper under both modes of analysis. The real problem arises because courts have not limited special deposits to those arising out of trusts.

Courts themselves are the first to admit that their decisions in this area of law reveal "some fuzziness and overlap in the analysis." Some courts look to the law of trusts; others merely ask whether the deposit was created with a special purpose known to both the bank and the depositor; still others use these rules interchangeably.⁸⁸ From such confusion two main lines of authority have emerged. Under the majority or "legal" rule, a bank may effect setoff against a depositor, even though a third party has an interest in the depositor's account, provided the bank has no knowledge of such interest or of sufficient facts to put it on inquiry notice. Under the "equitable" rule, a bank may not effect setoff against account funds in which a third party has an interest, regardless of the bank's lack of knowledge, unless the bank detrimentally relied on the depositor's apparent sole ownership of the account.⁸⁹

Unfortunately, what constitutes an "interest" sufficient to invoke either rule remains unclear. Moreover, both rules miss the mark and go far beyond what should be their intended target. The United States Second Circuit Court of Appeals assessed the situation accurately:

It is indeed settled law that a bank cannot exercise a setoff against a deposit which is known by it to be dedicated to a special use, *e.g.*, for the sole purpose of meeting payrolls or paying taxes If in fact such deposits were 'made in trust,' as some courts have said, or constituted contracts between the depositor and the bank for the benefit of a third party who could enforce it against the bank, the cases could be explained on the simple

88. *In re Multiponics, Inc.*, 622 F.2d 725, 728 (5th Cir. 1980); *see also* *Kaufman v. First Nat'l Bank*, 493 F.2d at 1071-72.

89. *In re Triple A Coal Co.*, 55 Bankr. 806, 812 (Bankr. S.D. Ohio 1985) (quoting *TeSelle*, *supra* note 74, at 71-72). *See also* *Emile v. Bright*, 203 So. 2d 328, 329 (Fla. App. 1967), *aff'd*, 216 So. 2d 443 (Fla. 1968); *National Indemnity Co. v. Spring Branch State Bank*, 162 Tex. 521, 524, 348 S.W.2d 528, 529 (1961); *Commercial Discount Corp. v. Milwaukee W. Bank*, 61 Wis. 2d 671, 680-81, 214 N.W.2d 33, 37-38 (1974); Comment, *Bank's Right of Set-off - Iola State Bank v. Bolan*, 33 KAN. L. REV. 569, 573-74 (1985).

ground that the situation was not one of 'mutual debts or credits,' to which alone [the old Bankruptcy Act] applies. However, the principle seems to go beyond such cases and to include others.⁹⁰

The variety of situations that are included under this special purpose principle is staggering.⁹¹ Yet, at least to some extent, the principle is used unnecessarily. Proper trust analysis does not require that the trust be written, express, or even necessarily made known to the bank.⁹² This principle is demonstrated aptly by the facts of *South Central Livestock Dealers, Inc. v. Security State Bank*.⁹³

There, the depositor was in the business of feeding and otherwise caring for investors' cattle. The depositor would sell the fattened cattle, deduct fees and other related expenses from the proceeds, and then deposit the balance in its bank account. Clearly then, the depositor was acting as the investors' agent, and never had any true claim to all the proceeds. Accordingly, the court could have appropriately imposed an implied or constructive trust on the deposited proceeds. This action would have destroyed mutuality and prevented the bank from using the deposits to set off the debt owed it by the depositor.⁹⁴

Unfortunately, the court did not analyze the issue on trust principles or proceed in this manner. Instead of focusing on whether a third party had sufficient ownership rights in the deposited funds to restrict the accountholder's use of such funds, the court discussed simply whether the bank knew that the deposited funds

90. *In re Applied Logic Corp.*, 576 F.2d 952, 958 (2d Cir. 1978).

91. *E.g.*, *First City Nat'l Bank v. Long-Lewis Hardware Co.*, 363 So. 2d 770 (Ala. 1978) (deposits intended for automobile purchase were special and not available for setoff; equitable estoppel against the bank, although not argued, may otherwise support the result).

92. If the bank extends credit to the depositor in reliance on what it thinks are general deposits, the lack of mutuality should not necessarily destroy setoff rights. *See supra* note 89 and accompanying text.

93. 614 F.2d 1056 (5th Cir. 1980).

94. *See also* *Rodi Boat v. Provident Tradesmen's Bank & Trust Co.*, 236 F. Supp. 935 (E.D. Pa.), *aff'd*, 339 F.2d 259 (3d Cir. 1964) (debtor's unauthorized sale of collateral constituted grounds for a constructive trust on the deposited proceeds).

In a situation warranting an implied or constructive trust, if the bank has no notice of the structure of its depositor's business and accounting practices, setoff still would be improper but damages should be limited to return of the funds improperly set off.

"belonged" to some third party.⁹⁵ Such sloppy analysis leads to absurd and conflicting results.⁹⁶ More importantly, such analysis generates additional judicial confusion, leading to the use of these vague mutuality principles to resolve what are, and should be treated, as priority disputes.⁹⁷

Conflicting Resolutions of Priority

Priority disputes arise when a third party claims rights in one of the debts that setoff has or is about to reduce or extinguish. Admittedly, this fact alone makes priority very similar to mutuality, which also concerns the rights of third parties. Indeed, perhaps any functional difference is largely illusory. Yet, priority conflicts, as discussed in this Article, involve rights acquired in a definite manner and through a specific legislative scheme: for example, through

95. 614 F.2d at 1059-60.

96. For an absurd result, see *Iola State Bank v. Bolan*, 235 Kan. 175, 679 P.2d 720 (1984) (bank not permitted to set off debtor's account and held liable for conversion for not honoring checks because funds in account were found to "belong" to the debtor's suppliers, who were the payees). The issue presented in this case is more properly analyzed in the cases cited *infra* note 100.

For conflicting results, compare *In re Goodson Steel Corp.*, 488 F.2d 776 (5th Cir. 1974), and *Ribaudo v. Citizens Nat'l Bank*, 261 F.2d 929 (5th Cir. 1958) (both holding that mere designation of account as "Payroll Account" insufficient to render deposit special), with *In re Saugus Gen. Hosp.*, 7 Bankr. 347 (Bankr. D. Mass. 1980) (payroll account deposits were special and unavailable for setoff). The latter holding was affirmed on appeal. *In re Saugus Gen. Hosp.*, 698 F.2d 42, 46-47 (1st Cir. 1983) (expressly noting that special deposits were not limited by a "trust fund" theory).

Additional conflicting results are generated by the "special purpose" test itself, because jurisdictions are divided on whether to use the "legal" or "equitable" rule. See *supra* notes 88-89 and accompanying text.

97. Numerous decisions have improperly invoked the concept of mutuality to analyze what were essentially priority disputes. See *National Acceptance Co. v. Virginia Capital Bank*, 498 F. Supp. 1078 (E.D. Va. 1980), *aff'd in part and rev'd in part*, 673 F.2d 1314 (4th Cir. 1981) (unpublished opinion) (setoff against secured creditor); *Iola State Bank v. Bolan*, 235 Kan. 175, 679 P.2d 720 (1984) (setoff against payee of a check); *Cooper v. Nevada Bank of Commerce*, 81 Nev. 344, 403 P.2d 198 (1965); *Morrison Steel Co. v. Gurtman*, 113 N.J. Super. 474, 274 A.2d 306 (1971) (setoff against secured creditor); (setoff against landlord lienor); *Middle Atlantic Credit Corp. v. First Pa. Banking & Trust Co.*, 199 Pa. Super. 456, 185 A.2d 818 (1962) (setoff against secured creditor); *Commercial Discount Corp. v. Milwaukee W. Bank*, 61 Wis. 2d 671, 214 N.W.2d 33 (1974) (setoff against secured creditor); see also Note, *Conflicts Between a Bank's Common Law Right of Setoff and a Secured Party's Interest in Identifiable Proceeds*, 9 Loy. U. CHI. L.J. 454, 473 (1978) ("the courts have not treated setoff against [a] third party [with a security interest in] funds as a priority problem").

article 3, 4, or 9 of the Uniform Commercial Code.⁹⁸ A determination of whether such rights prime the setoff rights of an obligor must be made pursuant to the express provisions of that legislative scheme. If the statute or code is silent, the determination should be made with reference to the legislation's policies and purpose. If such policies and purpose are not undermined by the recognition and priority of setoff, then a setoff should be permitted.

In other words, priority concerns third-party rights acquired by statute; mutuality concerns other third-party rights. Use of mutuality concepts to protect statutory rights is inappropriate. If legislation creating commercial rights to a debt in a third party is not undermined by the use of setoff, then a common-law doctrine aimed at protecting such parties is, at minimum, superfluous. More likely, it becomes a legal eddy disrupting the free-flowing stream of commerce.

The priority disputes litigated most frequently can be segregated into the following five distinct groups, each governed by a different statute or article of the Uniform Commercial Code:

<u>Party Claiming Priority In Debt Subject to Setoff</u>	<u>Governing Statute</u>
1. Taxing Authority (via a notice of levy)	Tax Code
2. Check Payee (v. drawee bank)	Article 4
3. Garnishor	Garnishment Statute
4. Instrument Assignee	Article 3
5. Secured Creditor (v. obligor on collateral)	Article 9

The first of these conflicts pits creditors' setoff rights against the rights of a taxing authority that has levied on a debt owed to a delinquent taxpayer. In such instances, tax statutes and policies control the outcome, giving the issue little relevance to general commercial transactions.⁹⁹ The second conflict involves the right of

98. Articles 5, 7, and 8, garnishment statutes, and tax levy authorizations might also create rights involved in priority disputes.

99. See *Peoples Nat'l Bank v. United States*, 777 F.2d 459 (9th Cir. 1985); *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 345 F.2d 624 (9th Cir. 1965); *Bank of Nevada v. United States*, 251 F.2d 820 (9th Cir. 1957), *cert. denied*, 356 U.S. 938 (1958); *United States v. Sterling Nat'l Bank & Trust Co.*, 360 F. Supp. 917 (S.D.N.Y. 1973), *aff'd in part and*

a bank to effect setoff against a depositor after one or more checks drawn by the depositor have been presented for payment. In construing article 4 of the Uniform Commercial Code, courts have almost universally held that setoff may be effected any time before the draft has been finally paid, that is, by midnight on the next banking day after the item was presented.¹⁰⁰ Again, however, the issue has little relevance to the resolution of other priority disputes. The remaining three disputes are somewhat interrelated and, in the case of the last, lead to many diverse and improper results.

As with the second priority dispute, courts have almost uniformly held that the setoff rights of a garnishee defeat the rights of the garnishor.¹⁰¹ In one respect this uniformity is somewhat sur-

rev'd in part, 494 F.2d 919 (2d Cir. 1974) (all holding that setoff rights cannot defeat the rights of the IRS); *cf. Almi, Inc. v. Dick Corp.*, 31 Pa. Commw. 26, 375 A.2d 1343 (1977) (taxing authorities lost to Pennsylvania automatic setoff).

100. *E.g.*, *Hudgins v. Florida Fed. Sav. & Loan Ass'n*, 399 So. 2d 990 (Fla. Dist. Ct. App. 1981); *Conn v. Bank of Clarendon Hills*, 53 Ill. 2d 33, 289 N.E.2d 425 (1972); *Citizens Nat'l Bank v. Mid-States Dev. Co.*, 177 Ind. App. 548, 380 N.E.2d 1243 (1978); *Universal C.I.T. Credit Corp. v. Farmers Bank*, 358 F. Supp. 317 (E.D. Mo. 1973); *Stauffer Seeds, Inc. v. Nebraska Sec. Bank*, 222 Neb. 594, 386 N.W.2d 2 (1986); *Pracht v. Oklahoma State Bank*, 592 P.2d 976 (Okla. 1979); *Community Bank v. United States Nat'l Bank*, 276 Or. 471, 555 P.2d 435 (1976); *West Side Bank v. Marine Nat'l Exch. Bank*, 37 Wis. 2d 661, 155 N.W.2d 587 (1968). *But see* *H. Schultz & Sons, Inc. v. Bank of Suffolk County*, 439 F. Supp. 1137 (E.D.N.Y. 1977); *Iola State Bank v. Bolan*, 235 Kan. 175, 679 P.2d 720 (1984) (payee had security interest in funds and bank acted in bad faith); Note, *Bank Procedures and the U.C.C.—When is a Check Finally Paid?*, 9 B.C. INDUS. & COMM. L. REV. 957 (1968) (criticizing *West Side Bank*).

Recent cases on a bank's right to charge back provisional settlements of credit card receivables have invoked similar article 4 principles in finding that such setoff rights warrant relief from the automatic bankruptcy stay. *In re Twenty-Four Hour Nautilus Swim & Fitness Center, Inc.*, 81 Bankr. 71 (D. Colo. 1987); *In re United Sciences of Am., Inc.*, 84 Bankr. 79 (Bankr. N.D. Tex. 1988).

101. *E.g.*, *Valley Nat'l Bank v. Hasper*, 6 Ariz. App. 376, 432 P.2d 924 (1967); *Walters v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 59 P.2d 983 (Cal. 1936), *modified*, 9 Cal. 2d 46, 69 P.2d 839 (1937); *Coyle v. Pan Am. Bank*, 377 So. 2d 213 (Fla. Dist. Ct. App. 1979); *First Nat'l Bank v. Sinkler*, 170 Ga. App. 668, 317 S.E.2d 897 (1984); *Bee Jay's Truck Stop, Inc. v. Department of Revenue*, 86 Ill. App. 3d 7, 407 N.E.2d 755 (1980); *Hoffman Chevrolet, Inc. v. Washington County Nat'l Sav. Bank*, 297 Md. 691, 467 A.2d 758 (1983); *Blow v. Blow*, 134 Mich. App. 408, 350 N.W.2d 890 (1984); *Herd v. Ingle*, 713 S.W.2d 887 (Mo. Ct. App. 1986); *Board of Trustees v. Durable Developers, Inc.*, 102 Nev. 401, 724 P.2d 736 (1986); *Industrial Comm'r v. Five Corners Tavern, Inc.*, 47 N.Y.2d 639, 393 N.E.2d 1005 (1979); *In re Taxes of Bob Dance Chevrolet*, 67 N.C. App. 509, 313 S.E.2d 207 (1984); *Almi, Inc. v. Dick Corp.*, 31 Pa. Commw. 26, 375 A.2d 1343 (1977); *cf. Gambino v. Culp*, 485 So. 2d 512 (La. Ct. App. 1986) (setoff denied because judgment lien preceded creation of debt to be set off).

prising. After all, the rights of a garnishor are controlled by statute in most states, and those statutes are not part of any uniform code. Yet, the basic concept of garnishment would support no other result. A garnishor steps into the shoes of the defendant and is subject to any defense the garnishee may have against the defendant.¹⁰² In essence, the garnishment is a sort of assignment in which the assignee cannot acquire rights greater than those possessed by the assignor.¹⁰³

This rationale and analysis play heavily in the resolution of the fourth dispute, whether setoff rights are primed by the rights of someone who was assigned one of the debts to be set off. If the assigned debt be in the form of a negotiable instrument¹⁰⁴ and if the assignee qualifies as a holder in due course,¹⁰⁵ the assignee clearly does and should take free of any setoff rights of the obligor on the instrument.¹⁰⁶ This rule underlies all of article 3 and is necessary to preserve the free transferability of negotiable instruments. The more interesting question arises when the instrument is not negotiable or the assignee otherwise fails to qualify as a holder in due course.

102. *Coyle*, 377 So. 2d at 216; *Sinkler*, 170 Ga. App. at 671, 317 S.E.2d at 900; *Hoffman Chevrolet*, 297 Md. at 712, 467 A.2d at 769; *Durable Developers, Inc.*, 102 Nev. at 410, 724 P.2d at 743; *Herd v. Ingle*, 713 S.W.2d at 888.

103. *Almi, Inc. v. Dick Corp.*, 31 Pa. Commw. at 34-35, 375 A.2d at 1348.

104. The requirements of negotiability are set forth in U.C.C. § 3-104(1) (1978), which provides:

Any writing to be a negotiable instrument within this Article must

- (a) be signed by the maker or drawer; and
- (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and
- (c) be payable on demand or at a definite time; and
- (d) be payable to order or to bearer.

105. *See id.* § 3-302 (defining holder in due course generally to mean someone who takes a negotiable instrument for value, in good faith, and without notice that it is overdue, has been dishonored, or is subject to any claim or defense).

106. One who qualifies as a holder in due course takes free of almost all defenses, and therefore would not take subject to the setoff rights of the instrument's maker. *See id.* § 3-305. This rule is perhaps the very heart of article 3, which seeks to protect the stream of commerce by providing for the unfettered flow of commercial paper.

The only relevant exception occurs where a holder acquires the instrument knowing that setoff had been previously effected, thereby discharging all or part of the instrument. *See id.* § 3-305(2)(e).

As is often the case, a banking situation provides the most common example of the problem: assignment of a debt in the form of a bank's certificate of deposit. Most certificates of deposit ("CD"s) issued by banks are not payable to the order of the purchaser nor to the bearer of the certificate. Accordingly, they lack the requirements of negotiability¹⁰⁷ and cannot create a holder in due course.¹⁰⁸

If an assignee does not acquire the rights of a holder in due course, basic law and common sense mandate that the assignee receive by way of the assignment no greater rights than those possessed by the assignor. Simply put, the assignor cannot assign what he or she does not have. Fortunately, the Uniform Commercial Code does incorporate this obvious principle. A transferee of an instrument receives only those rights of the transferor.¹⁰⁹ A holder not qualifying as a holder in due course takes an instrument subject to all valid claims and all defenses.¹¹⁰ Accordingly, the assignee of a nonnegotiable CD must take subject to the issuing bank's set-off rights against the CD's original purchaser.¹¹¹

Article 9 of the Uniform Commercial Code, which governs both security arrangements and transfers of accounts and chattel paper,¹¹² treats the assignees of such debt obligations similarly. Pursuant to section 9-318, such assignees take subject to all of the terms of the contract between the account debtor and the assignor and any other defenses or claims of the account debtor arising before the assignment.¹¹³ The official comment makes clear that

107. See *id.* § 3-104(1)(d), (3).

108. See *id.* §§ 3-302(1), 3-102(1)(e).

109. *Id.* § 3-201(1).

110. *Id.* § 3-306(a)-(b), quoted *infra* note 125.

111. *FDIC v. Pioneer State Bank*, 155 N.J. Super. 381, 382 A.2d 958 (1977); see also *Continental Bankers Life Ins. Co. v. Bank of Alamo*, 578 S.W.2d 625 (Tenn. 1979) (suggesting that the setoff rights of a CD issuer defeat the assignee's rights, but not reaching the issue because mutuality was lacking).

112. U.C.C. § 9-102(1)(b) (1978).

113. *Id.* § 9-318(1). This provision reads as follows:

Unless an account debtor has made an enforceable agreement not to assert defenses or claims arising out of a sale as provided in Section 9-206 the rights of an assignee are subject to

(a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and

such defenses or claims include setoffs.¹¹⁴

Presumably, then, the same result should obtain when the assignment is not outright, but merely one for security. In such a case, the assignee does not even receive all of the assignor's rights; he merely receives the rights of the assignor to the extent of the assignor's indebtedness.¹¹⁵ In fact, one court has followed this line of reasoning with respect to a CD pledged as security.¹¹⁶ However, proper analysis requires that security arrangements be evaluated through both the intricacies of article 9 and the basic rule of section 9-201, which makes a perfected security interest effective against all other creditors.¹¹⁷ Indeed, article 3 is expressly made subject to the provisions of article 9.¹¹⁸ In this context, disputes between secured creditors and parties seeking to effect setoff in a debt pledged to such a creditor, judicial confusion concerning setoff reaches its apex.

In *Citizens National Bank v. Bornstein*,¹¹⁹ the Supreme Court of Florida attempted a comprehensive analysis of the Uniform Commercial Code's treatment of the conflicting rights of a bank issuing a CD and a creditor secured in that CD. The court suggested that section 9-318(1) setoff defenses would protect the issuing bank from the secured creditor, but only if the bank qualified as an account debtor.¹²⁰ The court then proceeded to examine the Code's definitional provisions.

(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

114. *Id.* § 9-318 comment 1; see also *James Talcott, Inc. v. H. Corenzwit & Co.*, 76 N.J. 305, 387 A.2d 350 (1978).

115. *Kaw Valley State Bank & Trust v. Commercial Bank*, 567 S.W.2d 710, 712 (Mo. Ct. App. 1978); see also U.C.C. § 3-201(2) (1978).

116. *Kaw Valley State Bank & Trust v. Commercial Bank*, 567 S.W.2d 710 (Mo. Ct. App. 1978); see also *Bank of Crystal Springs v. First Nat'l Bank*, 427 So. 2d 968 (Miss. 1983) (setoff rights of a bank issuing a CD primed rights of creditor secured in that CD - decision based on non-code law because setoff priority disputes held outside the scope of article 9).

117. Except as otherwise provided expressly in article 9, "a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." U.C.C. § 9-201 (1978).

118. *Id.* § 3-103(2).

119. 374 So. 2d 6 (Fla. 1979).

120. *Id.* at 13. Section 9-318 facially applies only to assignment transfers, not security interests. Nevertheless, the court was apparently willing, and properly so, to award the section's protection to any account debtor whose obligation was pledged by the account creditor as security for a loan. Cf. *Business Fin. Services, Inc. v. AGN Dev. Corp.*, 143 Ariz. 603,

Account debtor is defined as a "person who is obligated on an account, chattel paper or general intangible."¹²¹ An examination of the definitions of these terms quickly reveals that a CD is neither an account nor chattel paper.¹²² Moreover, the definition of a general intangible expressly excludes any property constituting an instrument.¹²³ A CD qualifies as an instrument.¹²⁴ Thus, a CD is not a general intangible. Accordingly, the issuing bank was not an account debtor and was not entitled to the benefits of section 9-318(1).

Counsel for the bank next argued that, even if the bank were not entitled to the protections of section 9-318, the secured creditor's rights still were subject to the bank's setoff rights. For support, counsel pointed to section 3-306, which governs the rights of a holder of an instrument who does not qualify as a holder in due course.¹²⁵ Although section 3-306 facially applies only to negotiable

694 P.2d 1217 (Ariz. App. 1984) (account debtor's setoff rights defeated rights of creditor secured in that account).

121. U.C.C. § 9-105(1)(a) (1978).

122. An account is a "right to payment for goods sold or services rendered." *Id.* § 9-106. The bank purchased no goods or services. Chattel paper is "a writing or writings which evidence both a monetary obligation and a security interest." *Id.* § 9-105(1)(b). The bank gave no security for its obligation on the CD.

123. A general intangible is "any personal property . . . other than goods, accounts, chattel paper, documents, instruments, and money." *Id.* § 9-106.

124. An instrument can be a negotiable instrument, a certificated security, "or any other writing which evidences a right to the payment of money and . . . is of a type which is in ordinary course of business transferred by delivery with any necessary indorsement or assignment." *Id.* § 9-105(1)(i). A nonnegotiable CD fully satisfies this definition. *Smith v. Mark Twain Nat'l Bank*, 805 F.2d 278, 285-86 (8th Cir. 1986); *In re Dawson*, 52 Bankr. 444, 447 (Bankr. N.D. Ala. 1984); *General Elec. Co. v. M & C Mfg., Inc.*, 283 Ark. 110, 111-12, 671 S.W.2d 189, 190 (1984); *Republican Valley Bank v. Security State Bank*, 229 Neb. 339, 343, 426 N.W.2d 529, 532 (1988); *Old S. Life Ins. Co. v. Bank of North Carolina*, 36 N.C. App. 18, 27, 244 S.E.2d 264, 269 (1978); *First Nat'l Bank v. Lone Star Life Ins. Co.*, 524 S.W.2d 525, 529-30 (Tex. Civ. App.), *writ of error refused*, 529 S.W.2d 67 (Tex. 1975); *Wightman v. American Nat'l Bank*, 610 P.2d 1001, 1004 (Wyo. 1980); *see also Harris, Non-negotiable Certificates of Deposit: An Article 9 Problem*, 29 UCLA L. REV. 330, 363-75 (1981).

125. U.C.C. § 3-306 (1978). The relevant parts provide:

Unless he has the rights of a holder in due course any person takes the instrument subject to

(a) all valid claims to it on the part of any person; and

(b) all defenses of any party which would be available in an action on a simple contract.

instruments,¹²⁶ section 3-805 makes the provisions of article 3, except those relating to holders in due course, applicable to any instrument "which is otherwise negotiable within this Article but which is not payable to order or to bearer."¹²⁷

The court in *Bornstein* rejected this argument because it determined that the CD was not "otherwise negotiable." The court noted that negotiability requires that the instrument contain an "unconditional promise to pay a sum certain."¹²⁸ Like most CDs, the one in issue permitted assignment only with consent of the bank. The court therefore concluded that the promise to pay was not unconditional, and that section 3-805 did not apply. Because no other arguments were presented, the court held that the secured creditor took the CD free of the issuing bank's setoff rights.

Despite its attempt to properly interpret the Code, the Florida court's analysis suffers from two flaws. First, the decision sets up two rather bizarre anomalies. If the bank had provided security for its debt obligation on the CD, then the certificate and security agreement together would have constituted chattel paper.¹²⁹ As an obligor on chattel paper, the bank would have been an account debtor, entitled to the protections of section 9-318(1). By giving up more rights (i.e., security for its debt) the bank would have had more rights. On the other hand, if the CD had not restricted assignments, it would have been "otherwise negotiable." Section 3-805 would have applied, allowing section 3-306 to restrict the secured creditor's rights. Thus, by retaining fewer rights, the bank would have had greater rights. An analysis that interprets the Code as functioning in such a manner is hard to accept.

Second, the court determined that article 9 controlled the priority of setoff claims.¹³⁰ More recently, the Supreme Court of Minnesota concluded that non-Code law should govern priority disputes between secured creditors and parties seeking to effect setoff.¹³¹

126. *See id.* § 3-102(1)(e).

127. *Id.* § 3-805.

128. *Id.* § 3-104(1)(b).

129. *See supra* note 122 (defining chattel paper).

130. 374 So. 2d at 10. The court then implicitly relied on U.C.C. § 201 (1978) in ruling that the secured creditor's rights defeated the setoff rights of other creditors.

131. *State Bank v. First Bank*, 320 N.W.2d 723, 725 (Minn. 1982).

The Minnesota court held further that an issuer of a CD could effect setoff before paying a creditor secured in that certificate.¹³²

The question of whether article 9 controls the priority of setoff rights stems from section 9-104(i), which provides: "This Article does not apply to any right of setoff."¹³³ Professor Gilmore, one of the principal draftsmen of article 9, viewed this provision narrowly, as a mere declaration that setoff is not a security interest. To him, this point was so obvious that it should have been omitted.¹³⁴ Many courts have adopted the Florida Supreme Court's position, concluding that section 9-201 still governs the priority of security interests over setoff rights.¹³⁵ Other courts have implied as much.¹³⁶ The existence of section 306(4)(d)(i), which would appear superfluous if section 9-201 were not to generally subordinate setoff rights to perfected security interests, supports this result. However, several courts have interpreted section 9-104(i) more broadly, as totally excluding setoff rights from the coverage of article 9. They have concluded, therefore, that non-Code law should deter-

132. See also *Kaw Valley State Bank & Trust v. Commercial Bank*, 567 S.W.2d 710 (Mo. Ct. App. 1978); *Texas Bank & Trust Co. v. Spur Second Bank*, 705 S.W.2d 349 (Tex. Ct. App. 1986) (both permitting setoff of CD pledged as collateral). *Contra* *Citibank v. Interfirst Bank*, 784 F.2d 619 (5th Cir. 1986); *First Wis. Nat'l Bank v. Midland Nat'l Bank*, 76 Wis. 2d 662, 251 N.W.2d 829 (1977) (both denying setoff of a collateralized CD on vague mutuality principles); and *Republican Valley Bank v. Security State Bank*, 229 Neb. 338, 426 N.W.2d 529 (1988) (denying setoff because bank learned of pledge after setoff rights accrued but before setoff effected).

133. U.C.C. § 9-104(i) (1978); cf. *id.* § 9-306(4)(d)(i) (subjecting a security interest in deposited and commingled proceeds to setoff rights).

134. 1 G. GILMORE, *SECURITY INTERESTS IN PERSONAL PROPERTY* § 10.8 (1965).

135. *University C.I.T. Credit Corp. v. Farmers Bank*, 358 F. Supp. 317, 325 (E.D. Mo. 1973); *Continental Am. Life Ins. Co. v. Griffin*, 251 Ga. 412, 414, 306 S.E.2d 285, 287 (1983); *Citizens Nat'l Bank v. Mid-States Dev. Co.*, 177 Ind. App. 548, 556-59, 380 N.E.2d 1243, 1247-48 (1978); *Coachmen Indus., Inc. v. Security Trust & Sav. Bank*, 329 N.W.2d 648, 650 (Iowa 1983); *Southeastern Fin. Corp. v. National Bank*, 145 Mich. App. 717, 720-21, 377 N.W.2d 900, 900-01 (1985); *Associates Discount Corp. v. Fidelity Union Trust Co.*, 111 N.J. Super. 353, 357-58, 268 A.2d 330, 332 (1970); *Insley Mfg. Corp. v. Draper Bank & Trust*, 717 P.2d 1341, 1344-47 (Utah 1986); see also Note, *supra* note 97, at 462-65.

136. *Sterling Nat'l Bank & Trust Co. v. Southwire Co.*, 713 F.2d 684 (11th Cir. 1983); *Farns Assocs., Inc. v. South Side Bank*, 93 Ill. App. 3d 766, 417 N.E.2d 818 (1981); *Morris Plan Co. v. Broadway Nat'l Bank*, 598 S.W.2d 557 (Mo. Ct. App. 1980); *Anderson, Clayton & Co. v. First Am. Bank*, 614 P.2d 1091 (Okla. 1980); see also Rauer, *Conflicts Between Set-Offs and Article 9 Interests*, 39 STAN. L. REV. 235, 244 & n.31 (1986).

mine the priority of setoff rights.¹³⁷ Other courts have expressly declined to decide the issue.¹³⁸

This Article need not resolve whether article 9 or any other portion of the Uniform Commercial Code speaks to the priority of set-off rights. After all, the Article ends with a draft legislative proposal that resolves such priority disputes. If the priorities provided for in that proposal are compatible with the policies of the Code and consonant with general commercial practices,¹³⁹ effort is better directed at determining the priorities that make the most sense.

In this context, three related principles stand out. First, a person generally should not be able to assign rights which that person does not have. Second, a person should not be able to frustrate the reasonable commercial expectations of creditors through his or her unilateral action. Third, the Bankruptcy Code and Uniform Commercial Code treatment of creditor rights should be harmonized. A priority system founded on these principles will have much to recommend it.¹⁴⁰

137. *Citibank v. Interfirst Bank*, 784 F.2d 619, 620-21 (5th Cir. 1986) (based on Texas law); *State Bank v. First Bank*, 320 N.W.2d 723, 725 (Minn. 1982); *Bank of Crystal Springs v. First Nat'l Bank*, 427 So. 2d 968, 971 (Miss. 1983); *Republican Valley Bank v. Security State Bank*, 229 Neb. 339, 341, 426 N.W.2d 529, 531 (1988); *First Nat'l Bank v. Lone Star Life Ins. Co.*, 529 S.W.2d 67, 68 (Tex. 1975); see also 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, 204.

Most courts interpreting § 9-104(b), which removes landlord liens from the scope of article 9, have concluded that the priority provisions of article 9 do not govern conflicts between landlord liens and perfected security interests. See *Bates & Springer of Arizona, Inc. v. Friermood*, 109 Ariz. 203, 507 P.2d 668 (1973); *Dwyer v. Cooksville Grain Co.*, 117 Ill. App. 3d 1001, 454 N.E.2d 357 (1983); *Perkins v. Farmers Trust & Sav. Bank*, 421 N.W.2d 553 (Iowa 1988); *Hartwell v. Hartwell Co.*, 167 N.J. Super. 90, 400 A.2d 529 (1979); *National Inv. Trust v. First Nat'l Bank*, 88 N.M. 514, 543 P.2d 482 (1985); *Associates Fin. Serv., Inc. v. Solomon*, 523 S.W.2d 722 (Tex. Civ. App. 1975). But see *Peterson v. Ziegler*, 39 Ill. App. 3d 379, 350 N.E.2d 356 (1976) (disapproved of in *Dwyer*).

138. *First Nat'l Bank & Trust Co. v. Iowa Beef Processors, Inc.*, 626 F.2d 764, 769-70 (10th Cir. 1980); *National Acceptance Co. v. Virginia Capital Bank*, 498 F. Supp. 1078, 1083-85 (E.D. Va. 1980), *aff'd in part and rev'd in part*, 673 F.2d 1314 (4th Cir. 1981).

139. See discussion *supra* text accompanying note 98, regarding resolution of priority conflicts without reference to mutuality concepts.

140. These three principles are not too dissimilar from the "first-in-time," "ostensible ownership," and "derivation" principles suggested in Rauer's article as the ones by which priority disputes should be resolved. See Rauer, *supra* note 136, at 236-37 & 245-47. The first principle listed is, essentially, Rauer's derivation principle. The second principle is similar to ostensible ownership. The third certainly includes a first-in-time aspect.

The cases holding that a garnishor takes subject to the setoff rights of the garnishee are helpful in illustrating the first two principles. Almost all of these decisions involved a judgment creditor possessing a valid judgment lien on all of the judgment debtor's property, including the debt obligation owed by the garnishee.¹⁴¹ Yet in none of those cases was the judgment lien sufficient to prime pre-existing setoff rights. This result makes perfect sense. Setoff rights would amount to little if any subsequent judgment lien could defeat them, particularly a lien arising from a suit that a defendant/debtor declined to defend, or from a proceeding of which a creditor with setoff rights had no notice.

Setoff rights would be similarly inconsequential if the unilateral assignment of one of the debts as security for a loan from a third party could defeat them. Put another way, a contractual lien acquired pursuant to article 9 should not be more pervasive than a general judgment lien.¹⁴²

Moreover, commercial practice does not seem to require a result different from the one this theoretical analysis suggests. When a commercial lender is asked to extend credit based on the security of one or more obligations owed to the borrower, that lender will routinely value the security by analyzing the borrower's likelihood of collecting. If the obligors on the debts pledged as security have setoff rights potentially capable of defeating the rights of the lender, that is merely one more factor for the lender to consider. Yet that fact alone will not undermine financing arrangements. When account debts are purchased, as they are frequently in accounts financing transactions, the purchaser must evaluate the set-

141. See *Walters v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 59 P.2d 983 (Cal. 1936), *modified*, 9 Cal. 2d 46, 69 P.2d 839 (1937); *Coyle v. Pan Am. Bank*, 377 So. 2d 213 (Fla. Dist. Ct. App. 1979); *First Nat'l Bank v. Sinkler*, 170 Ga. App. 668, 317 S.E.2d 897 (1984); *Bee Jay's Truck Stop, Inc. v. Department of Revenue*, 86 Ill. App. 3d 7, 407 N.E.2d 755 (1980); *Hoffman Chevrolet, Inc. v. Washington County Nat'l Sav. Bank*, 297 Md. 691, 467 A.2d 758 (1983); *Blow v. Blow*, 134 Mich. App. 408, 350 N.W.2d 890 (1984); *Herd v. Ingle*, 713 S.W.2d 887 (Mo. Ct. App. 1986); *Board of Trustees v. Durable Developers, Inc.*, 102 Nev. 401, 735 P.2d 736 (1986); *cf. Industrial Comm'r v. Five Corners Tavern, Inc.*, 47 N.Y.2d 639, 393 N.E.2d 1005 (1979) (involving tax warrant accorded status of a judgment lien); *In re Taxes of Bob Dance Chevrolet*, 67 N.C. App. 509, 313 S.E.2d 207 (1984) (involving tax lien).

142. See *Kaw Valley State Bank & Trust v. Commercial Bank*, 567 S.W.2d 710 (Mo. Ct. App. 1978) (a pledgee's interest in collateral is, to the extent of the pledgor's indebtedness, identical to that of the pledgor).

off rights of the account debtors because the purchaser takes subject to such rights.¹⁴³

However, the discussion thus far relates only to setoff rights that accrue prior to perfection of the security interest. Not all security interests in debts attach after the setoff rights of the debtor become exercisable. For instance, if a person pledges a CD as security for a debt, and then incurs liability to the bank issuing the CD, the bank's setoff rights do not clearly warrant priority over the secured creditor's rights,¹⁴⁴ particularly if, prior to the time it extended credit, the bank was given actual notice of the pledge or had constructive notice via a filed financing statement.¹⁴⁵ After all, if the secured creditor had contacted the issuing bank prior to extending credit to inquire about possible setoff rights, the creditor would have learned that none existed.

Proceeds from collateral are another example of security interests that may attach before setoff rights accrue. Frequently, a debtor who has collateralized his inventory will sell some and deposit the proceeds in a general bank account. If the debtor also owes money to that bank, the bank may acquire setoff rights in the deposited funds. In such a case, the security interest in the deposited funds will have attached and been perfected at the time they became proceeds of the collateral, prior to the time when setoff rights accrued. Even if the bank's setoff rights constitute a security interest, as the Bankruptcy Code provides, that interest will be subsequent in time to the secured creditor's perfected interest.

In other words, if a depositor gives away a security interest in the bank's debt to him, which he may if the debt were evidenced

143. See *supra* notes 113-14 and accompanying text.

144. Cf. *Kaw Valley State Bank*, 567 S.W.2d at 714 (priority of setoff rights expressly based on the fact that they predated the rights of the secured creditor).

145. Cf. *Republican Valley Bank v. Security State Bank*, 229 Neb. 339, 426 N.W.2d 529 (1988) (giving the pledgee of a CD priority over the issuing bank's setoff rights because the pledgee gave notice of its interest, although after setoff rights accrued, before bank affected setoff).

Because a CD constitutes an instrument, see *supra* note 124, a security interest in a CD must be perfected through possession, not filing. U.C.C. §§ 9-304(1), 9-305 (1978). Arguably, therefore, no creditor would have reason to search the appropriate records for such a financing statement and the statement should not impose constructive notice.

by a CD,¹⁴⁶ his act cannot bestow more rights than he himself had unless it creates a holder in due course. However, if he contracted away a security interest in certain collateral and its proceeds, his subsequent and unilateral deposit of them in a bank that may thereby have or thereafter acquire setoff rights should not prime the attached and perfected security interest in such proceeds.¹⁴⁷

A major exception to the priority of a perfected security interest in proceeds emanates from comment 2(c) to section 9-306 of the Uniform Commercial Code, which provides:

Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. . . .

One court has held that setoff itself is a transfer in the ordinary course of a bank's business and allows a bank to take free of a perfected security interest.¹⁴⁸ Of course, this ruling overlooks the fact that setoff is not in the ordinary course of the depositor's business.¹⁴⁹ It also emasculates the security interest in proceeds and the general priority over setoff that the security interest is to have.

A better conclusion might be that the bank's setoff rights have priority over the secured creditor's right to proceeds only when a bank extends new credit in reliance on the deposited proceeds (of course, if the bank either knew or had reason to know of the secur-

146. Cf. U.C.C. § 9-104(1) (1978) (excluding from the scope of article 9 the transfer of an interest in a deposit account, except to the extent such account contains proceeds of other collateral).

147. Cf. Rauer, *supra* note 136, at 248-53, 260-64. *But cf.* First Wis. Nat'l Bank v. Midland Nat'l Bank, 76 Wis. 2d 662, 668-70, 251 N.W.2d 829, 832-33 (1977) (rejecting this distinction but apparently not fully comprehending it).

148. Tuloka Affiliates, Inc. v. Security State Bank, 229 Kan. 544, 627 P.2d 816 (1981). The dissent in this case seems much better reasoned than the majority opinion. In fact, many if not most of the setoff cases recently decided by Kansas appellate courts have been analyzed improperly. See Iowa State Bank v. Bolan, 235 Kan. 175, 679 P.2d 720 (1984) (bank not permitted to set off debtor's account and held liable for conversion for not honoring checks because funds in account were found to "belong" to the debtor's suppliers, the payees) (criticized *supra* note 96); Carson v. Chevron Chem. Co., 6 Kan. App. 2d 776, 635 P.2d 1248 (1981) (assignee of proceeds from chose in action had priority over defendant/counterclaimant's right to set off judgments).

149. See, e.g., Brown & Williamson Tobacco Corp. v. First Nat'l Bank, 504 F.2d 998, 1003 (7th Cir. 1974) (setoff transfer held not within the ordinary course of business).

ity interest, such reliance would be unjustified). In fact, sections 9-308 and 9-309 of the Uniform Commercial Code create this result. By extending such new credit, the bank is giving new value for the instruments (money) in its possession. The bank's situation is, therefore, analogous to a purchaser of these instruments under section 9-308(b) and to a holder in due course under section 9-309, provided the bank satisfies the other criteria expressed in section 3-302.¹⁵⁰

In one respect, the results of this analysis seem anomalous. They suggest that a secured creditor's interest in collateral, such as a CD, is more easily primed than its interest in proceeds of collateral, such as deposited proceeds of inventory. Upon further reflection, however, one can see that the analysis is, if not formally based upon, at least inherently compatible with the principle underlying section 9-312(5) of the Uniform Commercial Code: first in time prevails. By effectively characterizing setoff as a security interest (perfected at the moment mutual debts exist and otherwise qualify for setoff), relative priorities can easily be resolved by determining whether the bank's interest preceded that of the creditor secured pursuant to article 9.

Several courts and commentators have rejected such treatment on conceptual grounds. They have concluded that a person cannot have a security interest in one's own property or indebtedness, as a bank would have if it were permitted to maintain a security interest in deposited funds.¹⁵¹ Yet such theoretical objections ignore reality by failing to acknowledge the real security that setoff rights

150. For some unexpressed reason, the notice elements of §§ 3-302 & 9-308(b) are not identical. See U.C.C. § 9-308 comment 2 (1978) ("a purchaser of a negotiable instrument might prevail under clause (b) even though his knowledge of the conflicting proceeds claim precluded his having holder in due course status").

151. See 1 W. SCHLICHTING, T. RICE, J. COOPER & S. CHAZIN, *BANKING LAW* § 11.03 (1985); Clark, *supra* note 67, at 198; Mitchell, *supra* note 13, at 163 & n.53; TeSelle, *supra* note 74, at 41. See also cases cited *supra* note 15, noting that funds deposited with a bank generally become property of the bank.

Although setoff rights have often been characterized as a "banker's lien," e.g., Kane v. First Nat'l Bank, 56 F.2d 534, 537 (5th Cir. 1932), many authorities distinguish the two by suggesting that such a lien properly applies only to tangible personal property, often securities, in the possession of the bank. Clark, *supra* note 67, at 197-98; TeSelle, *supra* note 74, at 40-41.

can give a bank or other mutual creditor.¹⁵² As one author observed aptly, "[f]aced with the fact that the commercial world views the bank's right of setoff as the equivalent of a security device, it makes little sense to give decisive weight to the rather metaphysical objection that one cannot have an interest in one's own indebtedness."¹⁵³

CONCLUSION

Up to this point, this Article has provided little more than a cursory review of existing law and the issues and inconsistencies that lie hidden and not so hidden therein. In part because the issues and inconsistencies exist and are important, the call for a uniform law of setoff is now almost ten years old.¹⁵⁴ What follows is a response to that call.

This response attempts to resolve the problems with the current law of setoff identified above. In this effort, the proposed statute establishes a procedure by which setoff may be effected, mandates notice to the party against whom setoff is effected, and, through this, fixes a time from which potential fraudulent transfers and bankruptcy preferences can be measured.

More importantly, the proposed Act tries to maintain a distinction between mutuality and priority issues. In performing this task, the Act treats setoff rights as a security interest and adopts the general rule that the first to perfect such an interest prevails. This analysis helps to harmonize the Bankruptcy Code treatment of setoff with the Uniform Commercial Code treatment. In addition, it is intended to comport with prevailing commercial practices and common sense.

The Act is not perfect. For example, as is true under existing law, a bank with setoff rights against one of its depositors may have no way to ascertain readily and reliably whether another creditor of the depositor has rights superior to the account depos-

152. See *United States v. Harris*, 249 F. Supp. 221, 224 (W.D. La. 1966) (allowing bank a security interest in deposited funds).

153. Mitchell, *supra* note 13, at 166-67; see also CAL. COM. CODE §§ 9104, 9302(1)(g) (West Supp. 1988) (which, contrary to the U.C.C., permit a creditor to have a security interest in a deposit account, even where the account is maintained with that creditor).

154. See Note, *supra* note 97, at 472.

its. Yet, while failing in the herculean task of solving all potential problems and inequities, the Act should solve more problems that it creates and answer more questions than it raises.

UNIFORM SETOFF ACT

TABLE OF CONTENTS

Article I - General Provisions

- § 101 Short Title
- § 102 Applicability
- § 103 Definitions
- § 104 Rules of Construction
- § 105 Obligation of Good Faith

Article II - Setoff Procedure

- § 201 When Right Available
- § 202 Scope of Right
- § 203 Special Rules
- § 204 Procedure to Effect Right
- § 205 Time Limitations

Article III - Effect of Setoff

- § 301 Constitutes Payment
- § 302 Further Relief
- § 303 Discharge of Others
- § 304 Payment After Setoff
- § 305 Improper Exercise of Setoff
- § 306 Good Faith

Article IV - Priority

- § 401 Holder in Due Course
- § 402 Garnishment and Judgment Liens
- § 403 Security Interests

UNIFORM SETOFF ACT

ARTICLE I - GENERAL PROVISIONS

§ 101 *Short Title*

This Act shall be known as the Uniform Setoff Act.

§ 102 *Applicability*

- (a) *This Act shall apply where a person effecting setoff resides in this State, where the situs of a debt owed to a person effecting setoff is in this State, or where setoff is raised as an affirmative defense, counterclaim, or cross-claim in a court proceeding in this State.*
- (b) *This Act shall replace all common law governing or concerning setoff and is designed to accompany and complement the United States Bankruptcy Code and the Uniform Commercial Code.*

COMMENT

As with any code, this legislation is intended to supplant all pre-existing law on the subject. This remains true regardless of whether such pre-existing law is consistent or inconsistent with this Act; all prior common law of setoff is intended to be repealed by this legislation. Note, however, that basic principles of common law which apply generally and in a variety of substantive areas, such as waiver, estoppel, and laches, may have application to matters and situations otherwise governed by this Act, as may statutes

or regulations which create special rights or prohibitions with respect to specific debts or types of debts.¹⁵⁵

§ 103 Definitions

- (a) *"Bank" means any person engaged in the business of banking by accepting deposits of money on account and for the benefit of its customers.*
- (b) *"Creditor" means a person to whom a debt is owed by a debtor.*

155. See, e.g., *In re Metropolitan Int'l, Inc.*, 616 F.2d 83 (3d Cir. 1980) (regarding waiver of setoff rights); *United Seeds, Inc. v. Eagle Green Corp.*, 223 Neb. 360, 389 N.W.2d 571 (1986) (bank estopped from exercising setoff).

Other areas of law that may have continuing relevance include: federal law regarding set-off of credit card debts, 15 U.S.C. § 1666h (1982); truth-in-lending disclosure requirements and other consumer protection legislation, see Clark, *supra* note 67, at 199-202; statutes or regulations that prohibit or restrict an employer from effecting setoff against an employee's wages, e.g., 8 CAL. CODE REG. § 11040.8 (1984) (prohibiting employers from reducing employee wage payments by the amount of any loss arising from a cash shortage, breakage, or equipment loss not caused by a dishonest or willful act); the Bankruptcy Code's exemption provisions, compare *In re Wilde*, 85 Bankr. 147, 148-49 (Bankr. D.N.M. 1988) (bank not permitted to effect setoff against property exempt under § 522 of the Bankruptcy Code) and *In re Pieri*, 86 Bankr. 208, 210 (Bankr. 9th Cir. 1988) (neither California law nor § 522 prohibits setoff against the debtor's exempt property); and various statutes that exempt certain funds, such as Social Security benefits and worker's compensation payments, from the reach of creditors. See Note, *Bank's Right of Setoff in Virginia*, 41 WASH. & LEE L. REV. 1603 (1984); Hagedorn, *Bank Setoff in Washington - Is it a Right Without Restriction?*, 15 GONZ. L. REV. 989, 999-1000 (1980).

Courts have not been uniform in their interpretation of statutory exemptions. Several have permitted creditors to reach such funds once deposited in a bank, see *McCabe v. Fee*, 279 Or. 437, 568 P.2d 661 (1977); *Bernardini v. Central Nat'l Bank*, 223 Va. 519, 290 S.E.2d 863 (1982); *John O. Melby & Co. Bank v. Anderson*, 88 Wis. 2d 254, 276 N.W.2d 274 (1978); although most courts have not. See *In re Klein*, 10 Bankr. 356 (9th Cir. 1981); *Kruger v. Wells Fargo Bank*, 11 Cal. 3d 352, 521 P.2d 441, 113 Cal. Rptr. 449 (1974); *Barnhill v. Robert Saunders & Co.*, 125 Cal. App. 3d 1, 177 Cal. Rptr. 803 (1981); *Anderson v. First Nat'l Bank*, 151 Ga. App. 573, 260 S.E.2d 501 (1979); *Matthews v. Lewis*, 617 S.W.2d 43 (Ky. 1981); *Pease v. North Am. Fin. Corp.*, 69 Mich. App. 165, 244 N.W.2d 400 (1976); *Havelock Bank v. Hog Confinement Systems, Inc.*, 214 Neb. 783, 335 N.W.2d 765 (1983); *General Motors Acceptance Corp. v. Falcone*, 130 N.J. Super. 517, 327 A.2d 699 (1974).

This Act does not resolve the priority conflict that arises when such exempt funds are deposited in a bank with setoff rights. Resolution of that conflict seems better left to the statutes that provide the exemption and the policies that underlie them.

- (c) *"Debt" means a right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.*
- (d) *"Debtor" means a person who owes a debt.*
- (e) *"Liquidated" means fixed in amount or readily ascertainable in amount after simple calculation, with or without reference to additional known or readily ascertainable facts.*
- (f) *"Net Creditor" means a creditor who remains owed after his debt to a debtor is set off against a debt owed to him by that debtor.*
- (g) *"Net Debtor" means a debtor who remains indebted after his debt to a creditor is set off against a debt that creditor owes him.*
- (h) *"Person" means any individual, partnership, corporation, personal representative, or trustee recognized by state law as capable and competent to own property in his own right. "Person" does not include: the United States; any State, Commonwealth, District, Territory, municipality, or foreign state; or any agency, instrumentality, or subdivision of the United States or of any State, Commonwealth, District, Territory, municipality, or foreign state.*
- (i) *"Setoff" means the right to net a debt owed against a debt due and have only the difference transferred by or remain due by the net debtor to the net creditor.*
- (j) *"Situs" means, with reference to debts, the place where payment on a debt is due.*

COMMENT

The definition of "bank" in subsection (a) is taken from section 1-201(4) of the Uniform Commercial Code, but has been modified

to include only those banks which accept and hold deposits for customers. It also encompasses the broad number of entities entering the banking business, including those so-called nonbank banks which accept deposits and those brokerage houses which are traditionally thought of as depository banking services.¹⁵⁶

The definition of "debt" in subsection (c) is derived from the definition of "claim" under section 101(4)(A) of the Bankruptcy Code. It encompasses all rights to payment, however arising, and should be given the broad interpretation that "claim" has been given by bankruptcy courts. The part of the bankruptcy definition of "claim" not included as a "debt" here concerns the right to equitable remedies. But the mere fact that a person may be entitled to both the payment of money (whether as legal damages or pursuant to contract) and equitable remedies for the same wrong or obligation is not intended to prevent the payment right from constituting a "debt."

The term "liquidated" in subsection (e) encompasses not only sums certain, i.e., amounts owed on promissory notes or pursuant to a court judgment, but also amounts that need merely be calculated based on facts which are readily ascertainable and not subject to reasonable dispute. Examples include contract and rent obligations or escalations based on a specific index, such as the Consumer Price Index, All Urban Consumers, and promissory notes with interest tied to a base rate (or some increment above or below a base rate), such as the Federal Funds Rate, a named bank's prime lending rate, or even a similar rate ordinarily charged and published by the person effecting setoff or the person against whom setoff is invoked. In addition, a debt may be liquidated

156. The Drafting Committee on Amendments to the Uniform Commercial Code Current Payment Methods is apparently considering an expansion of the § 1-201(4) definition to include all "depository institutions" under 12 U.S.C. § 461(b)(1)(A). Miller, Ballen, Davenport & Vergari, *Uniform Commercial Code Survey: Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers*, 42 BUS. LAW. 1269, 1286 (1987). As the comment above attempts to show, the definition of "bank" should encompass all such institutions.

through estimation, if presented as a bankruptcy claim and estimated by the bankruptcy court.¹⁵⁷

A debt need not be characterized as entirely liquidated or entirely unliquidated; it may have both liquidated and unliquidated portions. Obvious examples include tort injuries, for which the medical bills may represent a liquidated portion but compensation for pain and suffering may be unliquidated, and a bank's liability for wrongful dishonor of a check, for which the amount of the check probably would be liquidated, but consequential damages may not. Of course, the mere fact that a debt or a portion of a debt is liquidated does not mean that it is undisputed, fixed, or matured.

Pursuant to the definition of "net creditor" in subsection (f), the party effecting setoff and the party against whom setoff is invoked may both be net creditors (and, accordingly, both be net debtors). This can happen, for example, where X owes Y a debt of \$200, all of which is available for setoff, and Y owes X a debt of \$300, of which only \$100 is available for setoff (the remaining portion being either unliquidated, unmatured, contingent, or disputed). If setoff is effected by Y to the extent of \$100, X will still owe Y \$100 (all of which will be available for further setoff) and Y will owe X \$200 (none of which will be available for setoff). Both will be net creditors (and net debtors) and will be entitled to enforce the portion of the debts remaining due as if setoff had never been exercised. *See* §§ 302, 303. Note, however, that if X had effected setoff, X would have been required to include a \$100 payment with his notice of setoff, and, thus, would not have been a net creditor. *See* § 204(c).

The definition of "person" in subsection (h) is derived from sections 101(14), 101(24) and 101(33) of the Bankruptcy Code. The additional language makes an individual acting for another in a separate legal capacity, such as an executor or trustee, a person separate from himself. This should make the requirements of mutuality in this Act and in the Bankruptcy Code easier to understand and apply. This provision does not alter, however, the com-

157. *See supra* notes 73 & 75.

mon-law rule that the executor of a decedent's estate is, when acting in such capacity and to the extent necessary to effect setoff, the same person as the decedent.¹⁵⁸ Moreover, this subsection does not change the prevailing bankruptcy rules regarding mutuality. A bankruptcy trustee or debtor-in-possession is deemed the same person as the bankruptcy debtor to the extent necessary to permit setoff of pre-petition claims with pre-petition debts or pre-petition claims with post-petition debts arising out of the same contract or transaction.¹⁵⁹

The additional language prevents a group or combination of persons (other than through partnership), such as joint tenants or tenants by the entirety, from constituting a single person, even when state law recognizes such group or combination as one capable of owning property in its own right.

As with the Bankruptcy Code, the exclusion of governmental units is made explicit in order to avoid any confusion that may arise, particularly if, for example, a municipality is incorporated and thus is legally a corporation.¹⁶⁰ Such exclusion also seems necessary to permit the state and federal governments to limit the scope of setoff against them, to assign superior priority to their own setoff rights, and to avoid conflict with the various state statutes, policies, and immunities that frequently apply when a gov-

158. See Comment, *supra* note 2, at 266, and cases cited therein.

159. See, e.g., *In re Elsinore Shore Assocs. v. First Fidelity Bank*, 67 Bankr. 926, 936 (Bankr. D.N.J. 1986) (pre-petition claims and debts and post-petition claims and debts may be set off, but pre-petition obligations may not be set off against post-petition obligations); see also *In re T & B Gen. Contracting, Inc.*, 64 Bankr. 291, 293 (Bankr. M.D. Fla. 1986) (no mutuality between a pre-petition debt and a post-petition claim); *In re Garcia*, 23 Bankr. 266, 267-68 (N.D. Ill. 1982) (no mutuality between a pre-petition claim and a post-petition debt); *In re All-Brite Sign Serv. Co.*, 11 Bankr. 409, 411-13 (Bankr. W.D. Ky. 1981) ("The filing of the petition marks the time at which mutuality ceases," and any money deposited thereafter, or check collected thereafter, although deposited pre-petition, is unavailable for setoff); accord *In re Nelson*, 6 Bankr. 248, 249-50 (Bankr. D. Kan. 1980) (pre-petition claim and post-petition debt in Chapter 7 proceeding). Apparently, the rule prohibiting setoff of pre-petition obligations against post-petition obligations does not apply when the obligations arise out of the same contract, so that recoupment would be available. See cases cited *infra* note 165.

160. See H.R. No. 95-595, 95th Cong., 1st Sess. 311-14 (1977).

ernmental agency attempts to effect setoff.¹⁶¹ Accordingly, the relative priority of setoff rights to a tax lien or levy, although perhaps indirectly affected, is not expressly covered by this Act. Resolution of such conflicting rights is left to the law of the taxing authority.¹⁶²

Moreover, by omitting governments from the scope of this Act, no need exists to determine which agencies and instrumentalities will be treated as the same person for mutuality purposes,¹⁶³ and setoff, as defined, will involve no state action.¹⁶⁴ This obviates the need to consider and address due process concerns.

"Setoff" is purposefully defined broadly in subsection (i) and encompasses the common law of recoupment as well as setoff. Accordingly, this Act supplants the common law of recoupment. *See* § 102(b). Moreover, this legislation abrogates all differences between recoupment and setoff. Any relevance the distinction may still have is limited to situations that this Act does not reach.¹⁶⁵

161. *See, e.g.*, *FDIC v. Smith*, 466 F. Supp. 843 (N.D. Ga. 1979) (protecting the FDIC from setoff); *Ainsworth v. Cincotta*, 79 Or. App. 574, 721 P.2d 455 (1986) (implementing state policy regarding insurance companies); *Bonelli v. State*, 71 Cal. App. 3d 459, 139 Cal. Rptr. 486 (1977) (protecting retirement benefits from setoff).

162. *Cf. Peoples Nat'l Bank v. United States*, 777 F.2d 459 (9th Cir. 1985) (IRS notice of levy defeated bank's setoff rights); *Pittsburgh Nat'l Bank v. United States*, 657 F.2d 36 (3d Cir. 1981) (IRS notice of levy primed by bank's automatic setoff); *United States v. Citizens & S. Nat'l Bank*, 538 F.2d 1101 (5th Cir. 1976) (IRS notice of levy defeats bank's subsequent effort to effect setoff), *cert. denied*, 430 U.S. 945 (1977); *Almi, Inc. v. Dick Corp.*, 31 Pa. Commw. 26, 375 A.2d 1343 (1977) (IRS lien primed by garnishor's setoff rights); *see also* 26 U.S.C. § 6323(a), (h)(1) (1982) (regarding the relative priority of federal tax liens and security interests).

163. *See In re Rinehart*, 76 Bankr. 746, 749-55 (Bankr. D.S.D. 1987) and cases cited therein.

164. *See, e.g.*, *Fletcher v. Rhode Island Hosp. Trust Nat'l Bank*, 496 F.2d 927 (1st Cir. 1974); *Bichel Optical Labs., Inc. v. Marquette Nat'l Bank*, 487 F.2d 906 (8th Cir. 1973); *Kruger v. Wells Fargo Bank*, 11 Cal. 3d 352, 521 P.2d 441, 113 Cal. Rptr. 449 (1974); *Meyer v. Idaho First Nat'l Bank*, 96 Idaho 208, 525 P.2d 990 (1974); *Hibernia Nat'l Bank v. Lee*, 344 So. 2d 16 (La. Ct. App. 1977); *Nietzel v. Farmers & Merchants State Bank*, 307 Minn. 147, 238 N.W.2d 437 (1976); *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wash. App. 530, 518 P.2d 734 (1974).

165. *Cf. In re Buttes Resources Co.*, 89 Bankr. 613 (S.D. Tex. 1988) (creditor with recoupment rights was not restricted by § 553 of Bankruptcy Code and was permitted to recoup pre-petition claim from both pre-petition and post-petition debts); *In re Mohawk Indus., Inc.*, 82 Bankr. 174, 177 (Bankr. D. Mass. 1987) (where recoupment lies, a pre-petition claim and post-petition debt may be netted out: "if a debtor seeks the benefit of a contract it

For instance, the distinction between setoff and recoupment may remain important when a governmental unit or agency is one of the parties involved. *But cf.* § 103(g) (defining "person" so as to exclude governmental units and agencies). By bringing suit, a governmental body may be waiving sovereign immunity to claims arising out of the same transaction or occurrence, thereby permitting a defendant to obtain recoupment, at least to the extent of the government's recovery. Sovereign immunity to unrelated claims may not be waived.¹⁶⁶ The Act proposed here does not address this issue and leaves the availability of setoff by and against governmental units, the doctrine of sovereign immunity, and the circumstances under which that immunity may be waived to other areas of law.

A debt need not arise in a forum state in order to have a situs in that state. The only requirement is that payment on the debt be due in the forum state. State law may vary on where payments are deemed due, but often payment is due wherever the contract or instrument directs or, in the absence of such direction, wherever the creditor resides.¹⁶⁷ Note that pursuant to section 2-310(a) of the Uniform Commercial Code, if a contract for the sale of goods is

must take the burden under that contract as well"); *In re Yonkers Hamilton Sanitarium, Inc.*, 22 Bankr. 427, 432-33 (Bankr. S.D.N.Y. 1982) (recoupment not subject to the limitations on setoff in § 553 of the Bankruptcy Code); *Waldschmidt v. CBS, Inc.*, 14 Bankr. 309, 313-14 (M.D. Tenn. 1981) (same rule under old Bankruptcy Act).

To the extent recoupment means any setoff right arising from a single transaction or occurrence, section 403(b) of this Act does give such rights a priority over previously perfected security interests. *See infra* note 189 and accompanying text.

166. *See Jicarilla Apache Tribe v. Andrus*, 687 F.2d 1324, 1344-45 (10th Cir. 1982); *EEOC v. First Nat'l Bank*, 614 F.2d 1004, 1007 (5th Cir. 1980); *FDIC v. Citizens Bank & Trust Co.*, 592 F.2d 364, 372-73 (7th Cir. 1979); *Frederick v. United States*, 386 F.2d 481, 487-88 (5th Cir. 1967); *United States v. Gold Mountain Coffee, Ltd.*, 601 F. Supp. 215, 217-19 (Ct. Int'l Trade 1984); *United States v. Yonkers Bd. of Educ.*, 594 F. Supp. 466, 469 (S.D.N.Y. 1984); *In re American Export Lines, Inc.*, 568 F. Supp. 956, 961-62 (S.D.N.Y. 1983).

167. *E.g.*, *Katz v. Richard Plumer Co.*, 479 So. 2d 874 (Fla. Dist. Ct. App. 1985); *Engineered Storage Sys., Inc. v. National Partitions & Interiors, Inc.*, 415 So. 2d 114, 114-15 (Fla. Dist. Ct. App. 1982); *Lucas Enters., Inc. v. Paul C. Harman Co.*, 273 Pa. Super. 422, 425, 417 A.2d 720, 721-22 (1980); *Insituform of N. Am., Inc. v. Miller Insituform, Inc.*, 695 S.W.2d 198, 200 (Tenn. Ct. App. 1985); *cf.* National Conference of Commissioners on Uniform State Laws, DRAFT AMENDMENTS TO UNIFORM COMMERCIAL CODE Article 3 (March 31, 1988) [hereinafter DRAFT AMENDMENTS] § 3-111 (making an instrument payable at the business or residence of the maker or drawee if the instrument is otherwise silent as to the place of payment).

silent as to the time and place of payment, payment is due at the time when, and at the place where, the buyer is to receive the goods (even if different from the time and place title is delivered). Presumably, the rule remains the same even when the seller agrees to sell on credit, thereby modifying the Uniform Commercial Code default time of payment; unless that agreement also changes the place of payment, payment will remain due where the buyer is to receive the goods.

By adding this definition to the Act, along with that portion of section 102(a) which references situs, persons conducting business in several states may take advantage of the provisions of this Act by requiring that payments due under the contracts they execute and the instruments they accept be due in a jurisdiction which has enacted this Act.

§ 104 *Rules of Construction*

- (a) *"Includes" and "including" are not limiting.*
- (b) *"Or" is not exclusive.*
- (c) *Masculine pronouns are for convenience only, they are not limiting.*

§ 105 *Obligation of Good Faith*

This Act imposes an obligation of good faith. All conduct, whether by act or omission, pursuant to any right, authorization, duty, or obligation provided for herein, is subject to this requirement.

COMMENT

This requirement is based upon section 1-203 of the Uniform Commercial Code and should be interpreted similarly. A basic principle underlying the entire Act is that all commercial dealing requires good faith. Particular application of this general principle is found in section 306, but the concept applies more broadly.

Example (5). A owes X;

X owes B.

If B has consented to the exercise of setoff, then mutuality exists and X may effect that right. Although A is technically not a creditor of X, B's consent essentially operates to assign B's rights against X to A. Thus, for the purpose of subsection (a), both A and B can be deemed to be creditors of X. Accordingly, with the appropriate manifestation of consent, A and B, or either of them, may also effect setoff, provided such action does not violate any of the rules in section 203.

If A alone effects setoff, consent would be manifested appropriately only if notification of such consent is transmitted to X in a reasonably reliable manner, i.e., by B or above B's signature and prior to or with the notice of setoff. Otherwise, X might reasonably believe A's action to be improper, and unnecessary disputes might result.

Example (6). A owes X;

X owes A, as trustee.

Pursuant to section 103(h) and the comment thereto, A as a trustee is a person distinct from A in his individual capacity. No mutuality exists here and setoff is not proper. If, however, the beneficiaries and the settlor consent, then Example (5) may govern the situation.

Example (7). Partnership owes X;

X owes Partner.

Pursuant to the Uniform Partnership Act, setoff is not permitted because Partner is only secondarily liable for Partnership debts. If, however, Partner consents, then Example (5) may again govern the situation.

Example (8). Partner owes X;

X owes Partnership.

Setoff is not permitted. Again, consent by Partnership (manifested by a partner other than the one owing X) may bring the situation within Example (5).

Example (9). A & B jointly owe X;

X & Y jointly owe A.

This pattern will probably not arise often. Nevertheless, all the creditors (A and X) are primary obligors. The exercise of setoff

cannot possibly harm B and Y. Accordingly, both A and X may effect setoff.

This Act does not expressly cover the mutuality problem presented by so called "special deposits." This section and section 103(h) suggest that a bank may not set off funds in a deposit account against a debt owed by the titular owner of that account, if, in fact, the owner is acting in a fiduciary capacity for another. The mere fact, however, that deposited funds are covered by a perfected security interest or subject to some other lien does not mean that they are held for the benefit of another. The rights of creditors are addressed in the sections on priorities, see §§ 401-403, and nothing is gained by confusing the concepts of priority and mutuality.¹⁶⁸ Special deposits should include only those funds deposited by a person acting in a true trust relationship for another. Such a trust may be express, implied, or constructive, but unless it is binding on the depositor, it should not affect the bank's setoff rights.¹⁶⁹ Nevertheless, the amount of notice to the bank and the level of agreement by the bank necessary to create a special deposit and destroy mutuality, and the degree of reliance by the bank necessary to overcome such lack of mutuality, is left to local law and article 4 of the Uniform Commercial Code.¹⁷⁰ Moreover, this Act does not cover the damages available for wrongfully using

168. See *supra* note 97.

169. Compare *In re Goodson Steel Corp.*, 488 F.2d 776 (5th Cir. 1974) (account designated as "Payroll Account" but on which depositor could draw freely contained general, not special, deposits); *In re Andrews*, 33 Bankr. 197 (Bankr. S.D. Fla. 1983) (setoff properly invoked against Totten trust deposits); and *National Bank v. Weiner*, 180 Ga. App. 61, 348 S.E.2d 492 (1986) (setoff of funds in an escrow account not improper), with *In re Todd*, 37 Bankr. 836 (Bankr. W.D. La. 1984) (bank may not setoff against depositor's individual debt any funds in depositor's Individual Retirement Account). See also *Filosa v. Pecora*, 44 Ill. App. 3d 912, 358 N.E.2d 1213 (1976) (bank setoff not proper against escrowed funds).

170. Cf. *In re Goodson Steel Corp.*, 488 F.2d 776 (5th Cir. 1974) (designation and use of account as one for payroll, absent agreement of bank, insufficient to make deposits therein special or otherwise create a trust fund); *United States ex rel. Crow Creek Sioux Tribe v. Tri-County Bank*, 415 F. Supp. 858, 868 (D.S.D. 1976) (maintenance of separate accounts for each federal grant received insufficient indication that bank had agreed to any special conditions on the deposits therein); see also *Berg v. Union State Bank*, 186 Minn. 529, 243 N.W. 696 (1932); *Brady v. American Nat'l Bank*, 120 Okla. 159, 250 P. 1006 (1926) (both holding that detrimental reliance by bank needed before deposited funds can be set off against trustee/depositor's individual debt).

special deposits to effect setoff. *Cf.* § 305(c), which governs a setoff lacking one of the requirements of section 202(a).

§ 202 *Scope of Right*

- (a) *Unless otherwise agreed, setoff may be effected only to the extent the debt owed to the person effecting setoff is matured as to time, fixed as to all contingencies, undisputed by all primary obligors, and liquidated in amount.*
- (b) *Unless otherwise agreed, the debt owed by the person effecting setoff may be unmatured, contingent, disputed, or unliquidated. To the extent any such debt is set off, such action accelerates to maturity any unmatured debt, waives any contingencies to or dispute of liability, and liquidates the amount.*
- (c) *For the purpose of this section, a debt is matured to the extent the debtor is insolvent, unless such insolvency preceded the creation of the debt.*

COMMENT

Absent agreement or consent, setoff is unavailable for any portion of a debt owed to the person effecting setoff that is unmatured as to time, contingent on any acts which have not yet been performed or on any events which have not yet happened, disputed as to liability by any primary obligor, or unliquidated in amount. Only those debts or portions of debts free of these defects may be set off against a mutual debt. Yet, just as an unliquidated debt can be liquidated through estimation by a bankruptcy court, *see comment to* § 103(e), a bankruptcy court can also fix a contingent debt,¹⁷¹ and ripen an unmatured debt,¹⁷² to permit setoff. Moreover, in the event a bankruptcy petition is not filed, and in order to

171. *See In re Flanagan Bros., Inc.*, 47 Bankr. 299 (Bankr. D.N.J. 1985); *In re Morristown Lincoln-Mercury, Inc.*, 42 Bankr. 413 (Bankr. E.D. Tenn. 1984); *see also supra* note 73.

172. *See In re Isis Foods, Inc.*, 24 Bankr. 75 (Bankr. W.D. Mo. 1982).

permit private setoff prior to bankruptcy court involvement, subsection (c) preserves the prevailing common-law rule that if a debtor is insolvent, setoff of an otherwise unmatured debt is permissible.¹⁷³

These restrictions do not apply to debts owed by the person effecting setoff because such defects are generally waivable, and thus, such restrictions are unnecessary to prevent undue detriment. In order to promote private settlements and the use of setoff, however, no admission, acceleration, or waiver, implied by the mere act of setoff, shall operate on any debt remaining after setoff. Moreover, if necessary, jurisdictions should modify their rules of evidence so that no such implied admission or waiver will be admissible into evidence in an action for further relief pursuant to section 302.

If the person effecting setoff has a co-obligor, setoff of an unmatured, contingent, disputed, or unliquidated debt may operate to such co-obligor's detriment (to the extent that contribution rights remain or to the extent that the co-obligor was a creditor on the other debt). General principles of agency govern such co-obligor's rights. If the person effecting setoff has at least apparent authority to bind the co-obligor, such setoff should remain effective.

§ 203 *Special Rules*

(a) *Delegated Debts*

- (1) *The delegate of a contractual debt may set off against the contract creditor only those debts owed by the creditor to the delegate which arise after the creditor receives notice of the delegation, or those other debts which arise out of the contract.*

173. See *supra* note 68.

- (2) *A creditor may set off against the delegate of a contractual debt any debt owed to the delegator arising before the creditor receives notice of the delegation, any debt owed to the delegate arising after receipt of such notice, or any other debt which arises out of the contract.*

(b) *Assigned Rights*

- (1) *The assignee of a right to payment on a debt may set off against the debtor only those debts owed by the assignee to the debtor that arise after the debtor receives notice of the assignment, or those other debts that arise out of the same transaction or contract that created the debtor's debt.*
- (2) *Except as provided in section 401, a debtor may set off against the assignee of a right to payment on a debt any debt owed by the assignor arising before the debtor receives notice of the assignment, any debt owed by the assignee arising after receipt of such notice, or any other debt which arises out of the same transaction or contract that created the debtor's debt.*

(c) *Consent*

If debts become mutual through the application of consent pursuant to section 201(b), and if such consent was not given at or prior to the time such debts arose, then setoff shall be deemed to occur after a delegation of duties or an assignment of rights, whichever is appropriate.

(d) *Wrongfully Acquired Debts*

A person who incurs a debt through some fraudulent or illegal means and for the purpose of effecting setoff may not use such debt to set off another debt.

(e) *Matured, Fixed, Undisputed, & Liquidated Debts*

Nothing in this section impairs or modifies the limitations on setoff in sections 201 and 202.

COMMENT

Paragraph (a)(1) restricts the selling of debt obligations to those who can make special use of them because they already are owed a debt by the creditor. Paragraph (b)(1) restricts the selling of rights to receive payment to those who can make special use of them because they already owe a debt to the debtor.

The former is particularly troublesome when the creditor is insolvent; the latter when the debtor is in default or is insolvent. In such instances, the use of setoff can have a markedly preferential effect over other creditors. Even beyond insolvency situations, the unrestricted exercise of setoff after the transfer of a debt can disrupt cash flow with an unexpected swiftness other uses of setoff cannot match.

Although section 553 of the Bankruptcy Code does restrict the preferential effect which transferred debts can produce,¹⁷⁴ the provisions here are drafted with sufficient breadth to apply outside of bankruptcy and insolvency situations, and to avoid interference with the reasonable expectations of the debtor/creditor not party to the delegation or assignment. As such, they do not apply if a novation has occurred (at which point a Bankruptcy Code preference attack would have a much greater chance of success).

Paragraphs (a)(2) and (b)(2) make clear that the rights of anyone not party to the assignment or delegation will not be diminished by such transfer. To the contrary, to a minor degree, setoff rights are enhanced by the availability of debts owed to or by the delegate or assignee. Aside from this minor enhancement, paragraph (b)(2) comports with section 9-318(1) of the Uniform Commercial Code.

174. See, e.g., Freeman, *supra* note 25, at 496-501.

Paragraph (b)(2) has the concomitant effect of resolving the priority conflict arising from assignments of nonnegotiable certificates of deposit. Because such certificates are nonnegotiable, an assignee will not acquire the rights of a holder in due course. Accordingly, the issuing bank will be free to use the obligation owing on the certificate to set off any debt the assignor owes the bank, provided such debt meets the requirements of section 202(a) and provided such debt was not created after notice of the assignment was received.¹⁷⁵ Cf. § 403(c), regarding priorities when the debt evidenced by a CD is pledged as security.

A debt that is renewed after notice of assignment is received should probably be treated as not having arisen prior to the receipt of such notice. In such a case, the bank knows of the assignment and therefore cannot reasonably rely on the certificate indebtedness for security. Of course, if renewal were required by contract, it should not affect a bank's setoff rights.

Subsection (c) deals with situations like those in Examples (5) through (8) of the comment to section 201. Consent may expand the scope of the right to setoff. But, just as an assignment or delegation should not operate to the detriment of a person not a party to such transfer, consent should not detrimentally affect a nonconsenting party. Accordingly, consent is to be tested under the same rules as a delegation or assignment. If in Example (5), Y consents to the exercise of setoff, such consent should be treated as an assignment of Y's right to receive payment on a debt. If such consent preceded the transactions or occurrences which created both debts, however, then the exercise of setoff cannot frustrate X's reasonable expectations, and the situation need not be treated as an assignment.

175. The rule of § 203(b)(2) extends to any transfer of an instrument, whether negotiable or nonnegotiable, in which the transferee fails to qualify as a holder in due course. This rule is similar, but not identical, to the rule proposed in the draft amendments to article 3. Pursuant to the draft amendments, a holder not qualifying as a holder in due course will be subject to setoff for the claims of the obligor arising out of "the transaction that gave rise to the instrument," but not to other claims of the obligor against the payee that predate the assignment. DRAFT AMENDMENTS, *supra* note 167, § 3-305.

Subsection (d) adopts and expands the rule of *Brunswick Corp. v. Clements*, 424 F.2d 673, 676 (6th Cir. 1970), that "a creditor of a bankrupt should not be permitted to pay himself through the device of setoff by converting the bankrupt's property, particularly at a time when he knows of the bankrupt's insolvency." Although section 553 of the Bankruptcy Code effectively limits most instances of such conduct, subsection (d) is necessary in case no bankruptcy filing is made or in case the debt is incurred more than 90 days before a bankruptcy filing.¹⁷⁶

Subsection (e) is presumably unnecessary, but is added merely to avoid any possible confusion. Phrases in subsections (a) and (b) such as "may set off . . . any debt" mean any debt otherwise qualifying for setoff under sections 201 and 202. Nothing in section 203 is intended to expand the scope of setoff beyond mutual debts or to remove the requirement that debts owed to the party effecting setoff be matured (or be owed by an insolvent), fixed, undisputed, and liquidated.

§ 204 . *Procedure to Effect Right*

- (a) *Setoff shall be effected by sending written notice thereof to every creditor owed on one or more of the debts involved.*
- (b) *Except as provided in subsection (d), setoff shall be effective upon dispatch of the notice required in subsection (a), or, if more than one such notice is required, upon the dispatch of the last of such notices, provided:*
 - (1) *Each such notice is sent in a manner reasonably certain to result in delivery within five calendar days;*

176. Cf. 11 U.S.C. § 548(a)(2), (d)(1) (1982 & Supp. IV 1986) (generally making such action avoidable by bankruptcy trustee as a fraudulent transfer).

- (2) *Any account or book entry customarily used to record the setoff is made within a reasonable time thereafter; and*
- (3) *The requirements of subsection (c) are satisfied.*
- (c) *Any person effecting setoff who, but for this subsection, would be a net debtor, must include with the notice required by subsection (a):*
 - (1) (A) *Remittance of that portion of his net debt which is matured as to time, fixed as to all contingencies, undisputed by all primary obligors, and liquidated in amount, unless such person is insolvent or is a bank effecting setoff against a depositor; or*
 - (B) *A statement of the amount remaining in the deposit account, available for withdrawal by the depositor, if such person is a bank effecting setoff against a depositor; and*
 - (2) *A description of exact nature and extent of any dispute, contingency, or lack of maturity or liquidation, to which the net debt remains subject.*
- (d) *Unless otherwise agreed, no other acts or events shall be necessary to effect setoff. If, by agreement, other acts or events are necessary, setoff shall be effective upon the latter of:*
 - (1) *Dispatch of all notices required by subsection (a), provided the requirements of paragraphs (b)(1), (2) & (3) are satisfied; or*
 - (2) *Performance of all the additional acts and occurrence of all the additional events required by agreement.*

COMMENT

This section specifies the action necessary to accomplish setoff¹⁷⁷ and therefore sets a time by which preferences and fraudulent transfers can be measured and sharpens the focus through which priorities can be determined. In addition, it should make bankruptcy stay issues easier to resolve; merely freezing a bankruptcy debtor's account will not constitute setoff and therefore should escape the prohibition in section 362(a)(7) of the Bankruptcy Code. This result is desirable because it prevents a flood of emergency stay litigation from banks trying to protect their setoff rights from the withdrawal of funds, and alleviates the conflict with the section 363 restrictions on the use of cash collateral.

Unlike most other provisions of this Act, subsection (a) imposes a requirement that cannot be waived by agreement or conduct. The notice requirement is absolute because setoff normally comes without warning and can frustrate the commercial plans of the person against whom it is effected. The burden of the requirement is thought to be slight compared to the benefits it can produce. Moreover, making the requirement absolute prevents overreaching by commercially powerful lenders who routinely might require their borrowers to waive notice.

Parties can appoint agents to receive notice, but notice to such agents will not discharge the requirement of subsection (a). It will merely be an additional duty under subsection (d). If the rule were otherwise, a lender could require its borrowers to appoint an agent for the purpose of setoff who is friendly to the lender. Such a situation is unacceptable because it would emasculate the notice requirement.

177. This section adopts, with modification and clarification, the rule expressed in *Baker v. National City Bank*, 511 F.2d 1016 (6th Cir. 1975). The *Baker* three-step test requires: (1) a decision to exercise the right of setoff; (2) some action to accomplish the right; and (3) some record evidencing that action. *Id.* at 1018. The procedure adopted here impliedly requires intent through the mandated notice. The notice also operates as an overt act. Unlike *Baker*, however, the bookkeeping entry, although necessary to an effective setoff, may follow the moment setoff becomes effective. The notice itself satisfies any need that may exist for immediate evidence that the setoff right has been exercised.

Nevertheless, someone must be appointed to receive notice for a corporation, association, or large partnership. Sending notice to the president, board of directors, or managing partner may be appropriate for small organizations, but is clearly unacceptable as a universal rule. Although the Act does not state expressly, notice will be sufficient if sent to the person most directly connected with the creation of the debt to be set off, such as the signatory on a deposit account or contract.

Notices properly addressed, prepaid, and sent by telegraph, telex, express mail service, or by first class United States mail for domestic delivery, as proper and effective under subsection (b). The provision is, however, not so limited, and approves expressly of any other similarly reliable transmission method. A notice is effective despite no actual delivery, if the service by which it was sent is sufficiently swift and reliable. Of course, if the person effecting setoff learns of the failed delivery and neglects to take reasonable steps to ensure that notice is received in a timely manner, he may have violated the obligation of good faith. *Cf.* § 105.

Subsection (c) imposes a requirement, not in the common law, that persons effecting setoff accompany their setoff with payment of that portion of their debt remaining due that is matured, fixed, undisputed, and liquidated. This requirement was included not to penalize or discourage the use of setoff, but to make the private right a more complete resolution of the parties' dealings and further obviate the need for judicial involvement. This requirement was not imposed on insolvents, who are defined in section 101(29) of the Bankruptcy Code, because it would have severely limited their ability to effect setoff. The requirement was not placed on banks because maintaining their depositors' funds available for withdrawal seems sufficient, indeed preferable, for those depositors with one or more drafts in circulation.

In the event a portion of the remaining debt is unmatured, contingent, disputed, or unliquidated, *cf.* § 202(b), a statement of the exact facts rendering the debt not yet due, or subject to dispute as to liability or amount, must accompany the setoff notice. This statement will bind the person sending it, focus the parties on any

remaining differences between them, and thereby promote further settlement. Moreover, it limits court inquiry during a subsequent suit.

Subsection (d) permits contracting parties to require other acts or events before setoff will be effective. These acts may include a particular means of sending notice, additional written or telephonic notice, the passing of a specified amount of time after dispatch, or receipt of the required notice. In any event, the requirement of subsection (a) remains unaltered.

§ 205 *Time Limitations*

Setoff must be effected before the debt owed to the person effecting setoff is barred by the applicable statute of limitations. When, however, the debt owed to the person effecting setoff arises out of the same transaction or occurrence as the debt owed by the person effecting setoff, setoff may be effected any time before the debt owed by the person effecting setoff is barred by the applicable statute of limitations.

COMMENT

This provision is intended to make setoff subject to the statute of limitations which governs the debt owed to the person effecting setoff. It also addresses the situation in which two debts arise out of the same transaction or occurrence and the applicable limitations period runs after the date a complaint is filed by one of the creditors but before the other's answer is due. This section adopts and expands the common-law equitable rule that recoupment will be allowed to prevent or reduce a judgment for the plaintiff in such a situation (but not for affirmative relief). In other words, a debtor may now counterclaim for an obligation barred by the applicable statute of limitations if the debtor was sued before the statute ran

out on a related claim¹⁷⁸ or may simply effect setoff to the same extent.

178. See C. WRIGHT, LAW OF FEDERAL COURTS 393-94 (3d ed. 1976), and cases cited therein.

ARTICLE III - EFFECT OF SETOFF

§ 301 *Constitutes Payment*

- (a) *Exercising the right to setoff shall constitute payment of the debt owed to the person effecting setoff to the extent such debt is netted out.*
- (b) *Exercising the right to setoff shall constitute payment of the debt owed by the person effecting setoff to the extent:*
 - (1) *Such debt is netted out; and*
 - (2) *If payment accompanies the notice of setoff, the amount of such payment.*

COMMENT

This section makes clear that effecting setoff (when the right to do so is available) operates as if the portion of each debt set off actually had been paid. Coupled with section 204, which governs when and how setoff is to be effected, this section may prevent a person against whom setoff was effected from validly declaring a default on the obligation giving rise to the debt due him. For example, if Tenant owes Landlord his periodic rent obligation and Landlord owes Tenant on some other obligation (promissory note; partial leaseback, etc.), Tenant may effect setoff and, if his exercise of setoff was proper, Tenant will not have defaulted on the payment obligation in his lease.

§ 302 *Further Relief*

Exercising the right to setoff shall not affect, modify, or impair the rights of any net creditor to seek and obtain further recovery from the net debtor for any portion of the debt owed by the net debtor which was not set off.

COMMENT

The exercise of setoff should not in any way limit further recovery or restrict other rights and should not operate as an election of remedies, even in those jurisdictions that require such an election.¹⁷⁹ A contrary rule would overly burden the right.

§ 303 *Discharge of Others*

Unless otherwise agreed, neither exercising the right to setoff nor failing to exercise such right when available shall discharge any surety, co-obligor, or security for any debt.

§ 304 *Payment After Setoff*

- (a) *If, after receiving notice of setoff, a person receives payment of all or part of the netted-out debt owed to him, he shall be liable for and, within a reasonable time, shall refund such payment.*
- (b) (1) *If, after setoff, the person effecting setoff receives payment of all or part of the netted-out debt owed to him, he shall be liable for and, within a reasonable time, shall refund such payment.*

179. Several jurisdictions treat setoff as an election of one of two or more exclusive means to collect a debt. See *Woodruff v. California Republic Bank*, 75 Cal. App. 3d 108, 141 Cal. Rptr. 915 (1977); *Forastiere v. Springfield Inst. for Sav.*, 303 Mass. 101, 20 N.E.2d 950 (1939); *Melson v. Bank of New Mexico*, 65 N.M. 70, 332 P.2d 472 (1958); *Zion's Sav. Bank & Trust Co. v. Rouse*, 47 P.2d 617 (Utah 1935).

Most jurisdictions, however, have no such rule. See *Jensen v. State Bank*, 518 F.2d 1, 6-7 & n.9 (8th Cir. 1975); *United States ex rel. Crow Creek Sioux Tribe v. Tri-County Bank*, 415 F. Supp. 858, 869 (D.S.D. 1976); *Bee Jay's Truck Stop, Inc. v. Department of Revenue*, 86 Ill. App. 3d 7, 407 N.E.2d 755 (1980); *Nietzel v. Farmers & Merchants State Bank*, 307 Minn. 147, 238 N.W.2d 437 (1976); *Frank Briscoe Co. v. Suburban Trust Co.*, 100 N.J. Super. 431, 242 A.2d 54 (1968); *Blust v. Yonkers Nat'l Bank & Trust Co.*, 260 A.D. 947, 23 N.Y.S.2d 512 (1940); *Keller v. Commercial Credit Co.*, 40 P.2d 1018 (Or. 1935); *Harper v. First State Bank*, 3 S.W.2d 552 (Tex. Civ. App. 1928); *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wash. App. 530, 518 P.2d 734 (1974); *cf. In re Saugus Gen. Hosp.*, 698 F.2d 42, 45 (1st Cir. 1983) (under Massachusetts law, setoff allowed only to the extent the creditor reasonably believes his security is inadequate).

- (2) *Payment received by a net creditor after such net creditor effected setoff shall be conclusively presumed to be payment of the net debt, and not payment of the netted-out debt, to the extent such payment does not exceed that part of the net debt which is undisputed as to liability, liquidated in amount, fixed as to all contingencies, and matured as to time.*

COMMENT

Although subsection (a) applies to all persons and should be so construed, it deals primarily with banks that effect setoff against a customer by sending the proper notice but who then fail to debit the customer's account and permit the customer to withdraw funds from the account or checks drawn on the account to clear.

The drafter considered making such payments after setoff a revocation of setoff, but such a rule was thought both to be unnecessary and to present priority problems. Moreover, unless carefully restricted, such a provision might give creditors too much power, entitling them to unilaterally revive a debt and any commensurate default on that debt after having effected setoff. That might permit such a creditor to pursue other default remedies under circumstances in which that result would be unfair.

Some part of the debt owed by the person exercising setoff may survive the notice of setoff and any accompanying payment, for example, a disputed, unliquidated, contingent, or unmatured portion, or the amount by which the debt owed by the person exercising setoff exceeded that owed by the other person. In such a case, payment after setoff may constitute payment of all or part of that net debt (possibly as an offer to resolve a dispute or liquidate a claim or because of a subsequent maturing of the debt). This subsection does not resolve whether a post-setoff payment constitutes payment of all or part of the net debt or payment of all or part of the debt netted-out. This result is simply a matter of intent. Each case must be judged on its own peculiar facts and the evidence of intent available and otherwise admissible. Of course, the amount of a post-setoff payment may be highly suggestive of which debt was

being paid, and any statement accompanying the payment normally should be considered binding and fully determinative.

Paragraph (1) of subsection (b) is the inverse of subsection (a). As with subsection (a), payment need not come from one of the parties to the setoff; it may come from any person purporting to act for the benefit of one of the parties to the setoff. Refund should be made to the transferor of the payment.

Unlike subsection (a), paragraph (2) of subsection (b) presumes that a post-setoff payment to a net creditor effecting setoff is payment of all or part of the net debt. This presumption is conclusive and does *not* require that the post-setoff payment be made after notice of setoff is received. In this way, the presumption is simply an extension of the self-help which this Act promotes. Were no presumption created, the net creditor simply could set off his refund obligation against any part of the net debt which remains available for setoff. Including the presumption as structured merely removes the necessity for additional notice and permits the net creditor to apply to the net debt any post-setoff payments received from third parties.

§ 305 *Improper Exercise of Setoff*

- (a) *Except as provided below, any attempt to effect setoff in circumstances other than those provided for above or to an extent greater than that permitted above, is invalid and without effect to the extent such right was unavailable.*
- (b) *Setoff shall not be improper merely because the debt owed to the person effecting setoff is disputed by one or more primary obligor. Only if such dispute is reasonable, held in good faith, and correct as a matter of law shall the exercise of setoff be improper.*
- (c) *An improper exercise of setoff shall not, in and of itself, subject the person attempting to effect setoff to*

liability. Such person shall, however, remain liable on his debt and shall be liable for any resulting or consequential damages proximately caused by the failure to pay his debt in a timely manner.

COMMENT

Subsection (a) merely provides that, to the extent an exercise of setoff is improper, it fails to extinguish either debt. It also covers the technicality that if an attempted setoff is wholly improper, section 302 will not be invoked. In such a situation, the attempted setoff is completely void and presumably cannot operate as an election of remedies in those jurisdictions that require creditors to pursue only one or a limited number of collection techniques.

Subsection (b) recognizes implicitly the unfortunate commercial reality that disputes about liability on a debt often arise in the absence of good faith, for purpose of delay, or without a substantial basis in law or fact. Such disputes do not make an exercise of setoff improper. Even when a reasonable factual or legal basis for the dispute exists, unless that dispute ultimately prevails so that the debt is extinguished, reduced, or otherwise modified, setoff will not be improper. This rule avoids the necessity of determining when a reasonable basis exists to support a losing claim and is supported by the probability that such use of setoff is not likely to have injured the person disputing liability.

Subsection (c) provides that the rights granted in this Act cannot serve as an independent basis for recovering damages.¹⁸⁰ However, the underlying failure to pay a debt when due can support a damages award. For example, if a bank wrongfully effects setoff against a depositor, the reduction in the deposit account balance reduces the amount available for the depositor to draw upon and can operate as a failure to timely pay a debt. Dishonor of a draft because setoff lowered the deposit account balance below the level

180. Cf. *Barnhill v. Robert Saunders & Co.*, 125 Cal. App. 3d 1, 177 Cal. Rptr. 803 (1981) (penalty for failing to pay wages inapplicable due to reasonable belief in availability of setoff).

necessary to cover the draft can then generate resulting or consequential damages for which the bank would be liable.

Moreover, although subsection (c) does not create a cause of action, it does not insulate a wrongful setoff from liability for tortious interference with business relations or other causes of action. If the conduct involved in improperly attempting setoff satisfies the elements of a tort, and if the necessary collateral circumstances and damages are present, liability will accrue.¹⁸¹

§ 306 *Good Faith*

- (a) *Any good faith attempt to effect setoff shall operate as a proper exercise of setoff for the purpose of sections 302 and 303.*
- (b) *For the purpose of this section, setoff is attempted in good faith if not prohibited by agreement and if noticed without actual knowledge of or reason to know that:*
 - (1) *The person against whom setoff is attempted disputes his liability on the debt he owes;*
 - (2) *The person against whom setoff is attempted disputes the amount of the debt he owes; or*
 - (3) *Some event has occurred or act has been performed which fulfilled a contingency and rendered unavailable for setoff the debt owed by the person against whom setoff was attempted.*

COMMENT

Section 105 governs the general obligation of good faith for the commercial dealings involved in setoff transactions. The definition

181. See *South Cent. Livestock Dealers, Inc. v. Security State Bank*, 551 F.2d 1346, 1351 (5th Cir. 1977).

of good faith in subsection (b) here is limited in effect to subsection (a): it does not govern the general obligation of good faith.

ARTICLE IV - PRIORITY

§ 401 *Holder in Due Course*

Nothing in this Act shall in any way limit the rights of a person qualifying as a holder in due course pursuant to § 3-302 of the Uniform Commercial Code.

COMMENT

This section was taken from section 9-309 of the Uniform Commercial Code. That provision makes clear that a filed financing statement provides insufficient notice to prevent a person from acquiring the rights of a holder in due course. Similarly, the mere fact that the holder of a negotiable instrument knows or has reason to know that the maker or drawer of such instrument may have setoff rights against the drawee or against any prior holder does not prevent such holder from becoming a holder in due course. *Cf.* § 3-304 of the Uniform Commercial Code.

This provision is a logical extension of the principles underlying article 3 of the Uniform Commercial Code and is added merely to avoid confusion. It is justifiable not only as a protection for the free marketability of negotiable instruments, but also as a matter of equity. The maker or drawer of a negotiable instrument, by recording his obligation in such form, creates the potential for generating an innocent holder in due course. As such, his rights should not defeat the rights of such a holder. Moreover, the maker or drawer is in the best position to know his own need for setoff rights, and can protect himself by refusing to create a negotiable instrument.

However, if a person otherwise qualifying as a holder in due course knows or has reason to know, prior to his acquisition of the negotiable instrument, that the maker or drawer has already exercised his setoff rights, then such holder's recovery on the instrument will be limited to the amount not discharged through setoff.

See §§ 1-201(27), 3-302(1)(c), 3-304(1)(b), 3-305(2)(e) of the Uniform Commercial Code.¹⁸²

Finally, this section does not copy that part of section 9-309 of the Uniform Commercial Code dealing with bona fide purchasers of a security or those to whom a negotiable document of title was duly negotiated. This omission is not meant to imply that this Act affects the rights of such purchasers and holders. Instead, their rights ordinarily do not conflict with setoff rights and therefore mention of them was deemed unnecessary.

§ 402 *Garnishment and Judgment Liens*

- (a) *Except as provided in subsection (b), a garnishor of a mutual debt shall be treated as an assignee of such debt, with service of the writ of garnishment constituting receipt of the notice of the assignment; the garnishee may effect setoff to the extent authorized under section 203(b)(2).*
- (b) *A judgment creditor acquiring a lien by operation of law on debts owed to the judgment debtor shall be treated as an assignee of such debts. Any person owing a debt to the judgment debtor shall be deemed to have received notice of the constructive assignment on the latter of: (1) the creation of such debt, or (2) perfection of the judgment lien. Persons owing a debt to the judgment debtor may effect setoff against the judgment creditor to the extent authorized under section 203(b)(2).*

COMMENT

Subsection (a) covers a garnishor who is not also a judgment creditor with a perfected lien. The subsection is necessary in the

182. Apparently, this result remains true under the draft revisions to article 3. See DRAFT AMENDMENTS, *supra* note 167, §§ 3-302(1)(b), 3-305(1)(b).

event a prejudgment writ of garnishment is issued or a judgment lien is not perfected properly through appropriate filing.

The subsection adopts in large measure the prevailing common-law and statutory rule that a garnishor acquires no greater rights in the garnished property than those his debtor had.¹⁸³ It permits the garnishee to set off of any mutual debt, otherwise qualifying for setoff, which arises before service of the writ of garnishment.¹⁸⁴ It also permits setoff of mutual debts arising out of the same transaction or contract, even if service of the writ of garnishment precedes such transaction or contract. For example, if the garnishee is involved in a automobile accident with the garnishment defendant after the writ of garnishment is served, claims arising out of that accident can be set off against each other. Similarly, if a bank makes a loan to the garnishment defendant after service of a writ of garnishment, requiring the defendant to make new or additional deposits in exchange, the bank may set off such defendant's loan indebtedness (provided it meets requirements for setoff in section 202(a)) against the bank's debt on such new or additional deposits.

Subsection (a) also permits a garnishee to set off any debt owed it by the garnishor arising after the writ of garnishment is served. This unlikely scenario effectuates essentially a three-way setoff, reducing or extinguishing: (1) the debt owed by the garnishee to the garnishment defendant; (2) the debt owed by the defendant to the garnishor; and (3) the debt owed by the garnishor to the garnishee.

183. See *supra* notes 101-102 and accompanying text; see also *Almi, Inc. v. Dick Corp.*, 31 Pa. Commw. 26, 34-35, 375 A.2d 1343, 1348 (quoting old common law for the point that service of a writ of attachment "has the effect of an equitable assignment of the thing attached").

184. If the debt does not otherwise qualify for setoff, for example because it is unmatured, the garnishor's rights would defeat the setoff rights of the garnishee. This result is contrary to the current law in several jurisdictions. *E.g.*, *Bee Jay's Truck Stop, Inc. v. Department of Revenue*, 86 Ill. App. 3d 7, 13, 407 N.E.2d 755, 760 (1980); *Hoffman Chevrolet, Inc. v. Washington County Nat'l Sav. Bank*, 297 Md. 691, 696, 467 A.2d 758, 761 (1983). Yet, the result accords with the current law in several others. *E.g.*, *Washington Loan & Banking Co. v. First Fulton Bank & Trust*, 155 Ga. App. 141, 143, 270 S.E.2d 242, 244-45 (1980); *Prince v. West End Installation Serv., Inc.*, 575 S.W.2d 831, 832-33 (Mo. App. 1978); *Almi Inc. v. Dick Corp.*, 31 Pa. Commw. at 34-35, 375 A.2d at 1348; see also *Walker v. Carolina Mills Lumber Co.*, 429 So. 2d 1065 (Ala. Civ. App. 1983) (setoff lost to garnishor when debt to be set off was contingent).

Finally, subsection (a) does not permit the garnishee to set off the debt it owes the garnishment defendant against a debt such defendant owes the garnishee that arises after service of the writ of garnishment. This result is necessary to prevent collusion between the garnishment defendant and the garnishee. It also comports with a treatment of setoff as a security interest. In such a situation, the setoff/security interest would have arisen after the writ of garnishment and therefore should not prime the rights of the garnishor.

Subsection (b) is little different from subsection (a), and all the potential uses of setoff under subsection (a) apply here as well.¹⁸⁵ This subsection merely changes the operative moment of the constructive assignment to the latter of the perfection of the lien or the creation of the debt. Again, this provision comports with the treatment of setoff as a security interest.

§ 403 *Security Interests*

- (a) *Except as provided in subsections (b) and (c), a creditor's setoff rights shall, upon attachment, have the status of a perfected security interest in the debt owed by such creditor.*
- (b) *In the case of mutual debts arising from the same transaction or occurrence, a creditor's setoff rights shall, upon attachment, have the status of a properly perfected purchase-money security interest in the debt owed by such creditor.*
- (c) *Where a person has perfected, through possession, a security interest in a debt, the setoff rights of the obligor on such debt shall, upon attachment, have the status of a properly perfected purchase-money security*

185. The subsection therefore adopts the rule of *Gambino v. Culp*, 485 So. 2d 512 (La. Ct. App. 1986), which prevents a garnishee from effecting setoff with a debt owed it by the garnishment defendant which arose after the garnishor's judgment lien.

interest in the debt owed to such obligor if, at the time such obligor became a party to mutual debts:

- (1) such obligor had no actual knowledge of the security interest; and*
 - (2) no financing statement covering the security interest had been filed.*
- (d) a creditor's setoff rights shall attach at the first instant when:*
- (1) such creditor is or becomes a party to mutual debts; and*
 - (2) the debt owed to such creditor satisfies the requirements of section 202(a).*

COMMENT

Subsection (a) codifies into state law the bankruptcy treatment of setoff rights as a security interest. It also operates as a companion to section 203(b)(2), preventing assignments, whether outright or for security, from priming pre-existing setoff rights. This latter function is accomplished through section 9-312(5) of the Uniform Commercial Code. Pursuant to that provision, "[c]onflicting security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier"¹⁸⁶

Thus, if setoff rights attach prior to the perfection or filing of a security interest in one or more of the debts subject to setoff rights, the creditor with setoff rights will have priority over a creditor with a security interest in one or more of such debts. On the other hand, if the security interest is perfected or a financing state-

186. U.C.C. § 9-312(5)(a) (1978). Paragraph (5)(b) will have no application because setoff rights are never unperfected security interests.

ment filed prior to the time setoff rights attach, the secured creditor wins the priority dispute.

Similarly, if an account is pledged as security for a loan, that pledge will not prime any prior setoff rights of the account debtor, although setoff rights attaching after a financing statement covering the account is filed¹⁸⁷ will be primed. Of course, the filing provides notice to the account debtor of the security interest, thereby permitting the account debtor to refrain extending credit or making a loan to the account creditor. If the extension of credit preceded the filing, but setoff rights did not attach at that time because the debt owed by the account debtor had not yet matured, then presumably the account debtor was not relying on his setoff rights to collect. Even if the extension of credit were in reliance on the future availability of setoff, such setoff rights will take subject to the secured creditor. Any other result would require a creditor secured in accounts to notify all the account debtors in addition to filing a financing statement. This result would be quite burdensome for a creditor secured in many accounts, particularly accounts which change daily, and may interfere unduly with account financing.

Subsection (a) also protects a creditor who is secured in proceeds that have been deposited in a bank or otherwise transferred into a debt owed to the debtor. In such a case, the setoff rights of the bank will necessarily attach after the security interest in proceeds attached. As long as the security interest in proceeds is perfected pursuant to section 9-306(3) of the Uniform Commercial Code, the debtor's unilateral action of depositing such proceeds in a bank with setoff rights will not prime the security interest, at least not to any extent greater than the insolvency limitation in section 9-306(4)(d)(ii).¹⁸⁸ Whether this insolvency limitation provision

187. Perfection can never precede filing because perfection in an account must be accomplished through filing. *See id.* § 9-302.

188. The policy behind § 9-306(4)(d)(ii) is unclear. The provision apparently replaces common-law tracing rules. *Maxl Sales Co. v. Critiques, Inc.*, 796 F.2d 1293, 1300 (10th Cir. 1986); *Fitzpatrick v. Philco Finance Corp.*, 491 F.2d 1288, 1291 (7th Cir. 1974); *In re Inter-mountain Porta Storage, Inc.*, 74 Bankr. 1011, 1014-15 (D. Colo. 1987).

should be removed from the Uniform Commercial Code is an issue not addressed by this Act but one which warrants consideration.

Nothing in subsection (a) impairs the protections provided in section 9-307 of the Uniform Commercial Code for buyers in the ordinary course of business.

Subsection (b), in conjunction with section 9-312(4) of the Uniform Commercial Code, gives setoff rights priority where the mutual debts arise out of the same transaction or occurrence. This result protects financing arrangements in which both debts are created at the same time from the rights of creditors who may be secured in certain after-acquired collateral. The debts created in such a transaction are not likely to be relied on by the secured creditor when it previously extended credit.

The subsection also applies to protect other types of mutual debts. For example, if two parties to an automobile accident are injured and thereby acquire claims against each other, no creditor of either of those parties will be able to defeat the setoff rights of the other party.

Note that section 9-312(4) gives priority to a purchase-money security interest over a previously perfected security interest only if the former is perfected "at the time the debtor receives possession of the collateral or within ten days thereafter."¹⁸⁹ However, with regard to setoff rights, this clause is necessarily satisfied by the use of the phrase "properly perfected." This rule is necessary for two reasons. First, no tangible collateral exists for the debtor to receive. Second, a contrary rule would only cause problems. For instance, if the clause in section 9-312(4) means that the rights of the creditor must attach, pursuant to subsection (d), within ten days after the debtor acquired the mutual debt owed to it by the creditor, then the automobile example above would be incorrect. In that case, the debts will not likely become fixed or liquidated (and therefore not attach under section 403(d)(2)) until long after they otherwise accrue. Accordingly, the last clause of section 9-312(4)

189. U.C.C. § 9-312(4) (1978).

does not apply to setoff rights having the status of a properly perfected security interest.

Subsection (c) covers any security interest in a debt perfected through possession, as authorized by section 9-305 of the Uniform Commercial Code. It is specifically intended, however, to address the situation in which a certificate of deposit is pledged to someone other than the issuer as security for a debt owed by the purchaser. Security interests in such instruments are ordinarily perfected through possession, which provides no actual or constructive notice of the pledge to the issuer. If the issuer then extends credit to the purchaser, relying on setoff rights in the certificate of indebtedness as security, the issuer's rights should defeat the rights of the secured creditor, who could have avoided the loss by providing the issuer with notice of its security interest. For simplicity, reliance is presumed conclusively when the issuer had no actual or constructive notice of the earlier pledge.¹⁹⁰

In many respects, this provision treats a security interest in a debt perfected through possession as an assignment of that debt, leaving the obligor all the setoff rights described in section 203(b)(2). Unlike an assignment, however, which generally restricts setoff rights to those debts arising before actual notice is received, this provision restricts setoff to those debts arising before actual or constructive notice is provided. This distinction was necessary to avoid undue interference with the effectiveness of financing statements, which, like possession, can be used to perfect a security interest in chattel paper.

190. Although a creditor cannot ordinarily perfect a security interest in an instrument by filing a financing statement, *see id.* § 9-304(1) and, therefore, instrument obligors and other commercial players have no cause to search for such filings, *see supra* note 145, permitting creditors to impose constructive notice in this manner does not appear incongruous. After all, subsequent to the adoption of this rule, an instrument obligor who, when extending credit, truly wishes to rely on that obligation and the setoff rights potentially connected therewith, will know to search the relevant repository of such records.

A financing statement filed against an instrument previously assigned may lie outside the apparent chain of the title (*i.e.*, if no notice of the assignment was given to the instrument obligor). Obviously, financing statements filed outside the apparent chain of title cannot provide constructive notice, particularly because the creditor could just as easily have actually notified the instrument obligor.

Subsection (c) does not impair the rights of a holder in due course, which are expressly protected in section 401.