Integration of Deposit Account Financing into Article 9 of the Uniform Commercial Code: A Proposal for Legislative Reform

Luize E. Zubrow

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Integration of Deposit Account Financing into Article 9 of the Uniform Commercial Code: A Proposal for Legislative Reform

Luize E. Zubrow*

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INTRODUCTION

This Article proposes that the scope of article 9 of the Uniform Commercial Code be expanded to regulate credit transactions secured by the many different types of consumer and business demand accounts, savings accounts, and nonnegotiable certificates of deposit. Article 9 expressly excludes the "transfer of an interest in any deposit account, . . . except as provided with respect to proceeds." This proposal would delete that exclusion. Concomitantly, the common law right of depositary institutions to extrajudicially set-off claims against deposit account collateral would be abolished and the law of pledge and assignments now applied to security transfers of interests in deposit account collateral would be displaced. By thus bringing deposit account financing wholly within the Uniform Commercial Code, the article 9 goal of creating a unified, comprehensive legal structure governing the hypothecation of...

1. Unless otherwise indicated, all references to articles, sections, and comments of the Uniform Commercial Code (U.C.C.) are to the 1978 official text. ALI & NAT'L CONF. OF COMM'RS ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE: 1978 OFFICIAL TEXT WITH COMMENTS (9th ed. 1978).

2. U.C.C. § 9-104(1). Although article 9 does not apply to a security interest in a "deposit account" as original collateral, it does allow a creditor with a security interest in other personal property to trace its interest to a deposit account that has been augmented by identifiable "proceeds" received by the debtor on the sale of the encumbered property. See U.C.C. § 9-306(1).

3. Set-off is the cancellation of cross-demands between two parties. The term commonly is used to cover both judicially supervised set-offs and automatic extinction of cross-demands. "Set-off" in this Article refers to extrajudicial set-off. See generally Comment, Automatic Extinction of Cross Demands: Compensatio from Rome to California, 53 CAL. L. REV. 224 (1965).

A depositor's interest in the bank account is properly characterized as a contract right to be repaid by the depositary institution. See sources cited infra note 32. Under the common law, such a chose in action can be pledged as collateral when reified in an "indispensable" instrument, like a negotiable certificate of deposit or a savings passbook. See infra notes 130-33, 139, and accompanying text. Alternatively, a security assignment can be used to transfer title to this form of intangible property. See E. FARNSWORTH, CONTRACTS §§ 11.1-11 (1982); see also infra notes 134-35 and accompanying text.
all types of personal property would be furthered. Moreover, debtors and creditors would be freed from historic constraints on the use of personal property as security. Although embodied in the common law, such restrictions have been rejected by the Code as inappropriate in modern commercial transactions.

Depositary institutions hold substantial deposits and supply a significant portion of consumer and business credit. In June 1983, commercial banks alone held approximately $1,300 billion in various demand, savings, and time deposit accounts. When the savings capital for savings and loan associations, the deposits of mutual savings banks, and the shares and deposits of credit unions are added, the total is approximately $2,100 billion. Federal deregulation measures, including substantial removal of interest rate ceilings, of minimum deposit restrictions

4. See U.C.C. § 9-102 comment. This Article focuses on the inclusion of deposit account financing within the article 9 framework and advocates the abolition of the common law right to set-off as part of that reform. The question of whether the common law right to set-off should be abolished where the mutually indebted parties are entities other than a bank and its customer is beyond the scope of this Article. The priority rules that presently govern such disputes, however, are discussed infra at notes 315-26 and accompanying text.


6. The following tables, based on Federal Reserve data, show total deposits in the monetary system, classified by type of institution and type of account:

<table>
<thead>
<tr>
<th>Total Deposits by Type of Monetary Institution</th>
<th>Billions</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>June 1983</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commercial Banksa</td>
<td>$1,329.5</td>
<td>61.3%</td>
</tr>
<tr>
<td>Savings and Loan Associations</td>
<td>603.2</td>
<td>27.8</td>
</tr>
<tr>
<td>Mutual Savings Banks</td>
<td>164.0</td>
<td>7.6</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>71.6</td>
<td>3.3</td>
</tr>
<tr>
<td><strong>Totalb</strong></td>
<td>$2,168.3</td>
<td>100.0%</td>
</tr>
</tbody>
</table>
and of mandatory penalties for early withdrawals,7 have ensured that these institutions will continue to be important suppliers of financial services.8 Also, in June of 1983, commercial

<table>
<thead>
<tr>
<th>Total Deposits by Type of Account</th>
<th>June 1983</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Billions</td>
</tr>
<tr>
<td>Demand Depositsa</td>
<td>$242.1</td>
</tr>
<tr>
<td>Other Checkable Depositsc</td>
<td>122.7</td>
</tr>
<tr>
<td>Money Market Deposit Accounts</td>
<td>367.3</td>
</tr>
<tr>
<td>Savings Deposits</td>
<td>326.3</td>
</tr>
<tr>
<td>Time Deposits—Small Denominationsd</td>
<td>723.9</td>
</tr>
<tr>
<td>Time Deposits—Large Denominationse</td>
<td>301.0</td>
</tr>
<tr>
<td>Total</td>
<td>$2,083.3</td>
</tr>
</tbody>
</table>

a. Exclusive of cash items in the process of collection, Federal Reserve float, and demand deposits due to other banks, U.S. government, and official institutions.

b. Deposit by type of institution, based on “Last-Wednesday-of-Month” series and “end of period” data; deposit by type of account based on “averages of daily figures,” not seasonably adjusted.

c. Includes negotiable orders of withdrawal (NOW) and automatic transfer series (ATS) accounts at all institutions, credit union share draft (CUSD) accounts at credit unions, and demand deposits at mutual savings banks.

d. Issued in amounts of less than $100,000.

e. Issued in amounts of $100,000 or more.


7. From 1978 to 1982, rising interest rates caused customers to withdraw funds from traditional depositary institutions in order to buy shares of money market funds. (A money market fund pools its shareholders’ investments to purchase relatively safe but large minimum denomination instruments such as commercial paper or treasury bills.) See Whitehead, MMDAs and Super NOWs: The Record So Far, Econ. Rev.: Fed. Reserve Bank Atlanta, June 1983, at 20.


8. Secretary of the Treasury Donald Regan, a member of the DIDC, reported to the Senate Committee on Banking, Housing and Urban Affairs on April 6, 1983:

In 1982, the DIDC took two major actions which have effectively halted the outflow of funds from depositary institutions. The DIDC . . . authorized depositary institutions to offer . . . the Money Market Deposit Account . . .

Secondly, as a result of the deregulation schedule . . . rate ceilings have been removed from deposits with a maturity of 2-½ years and over. In addition, a ceiling-free NOW, or transaction account, became effective on January 5, 1983.

Testimony of Hon. Donald T. Regan Secretary of the Treasury Before the Senate Committee on Banking, Housing and Urban Affairs, Treasury News (Dep't of
banks had approximately $1,100 billion dollars in loans outstanding (excluding interbank loans); if lending by savings and loan associations, mutual savings banks, and credit unions is added, the figure is approximately $1,700 billion.9

the Treasury press release, April 6, 1983), reprinted in NEW BANKS AND NEW BANKERS 1983, 385, 387 (Practising Law Institute 1983) [hereinafter cited as Regan Testimony]. During the four months following their authorization, $318 billion was placed in money market deposit accounts. See Whitehead, supra note 7, at 17.

Depositary institutions currently seek authority to offer a broad range of "nonbank" services including marketing securities, commodities, insurance, real estate, and travel services. The proposed Financial Institutions Regulation Act, S. 1609, 98th Cong., 2d Sess. (1984), presently before Congress, would allow the sale of such services through separate subsidiaries of bank holding companies. The bill is the successor to legislation introduced at the request of the Reagan administration as the "Bank Holding Company Deregulation Act". See Statement by Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, before the Senate Committee on Banking, Housing and Urban Affairs (Sept. 13, 1983), reprinted in 69 FED. RESERVE BULL. 757, 759 (1983) [hereinafter cited as Volcker Statement].

Sears Roebuck & Co., which in recent years has acquired a real estate firm, a securities firm, and a savings and loan association, and which also owns All-State Group Insurance companies, has opened financial service centers in many of its retail outlets. Thus a customer can at a single location purchase merchandise, buy stocks and bonds, real estate, and insurance, and use an automatic teller for banking transactions. See Financial Industry in Turmoil as Reluctant Congress Stalls on Bank Deregulation Issue, 41 Cong. Q. Weekly Rep. (Cong. Q. Inc.) 1899 (Sept. 10, 1983) [hereinafter cited as Financial Industry in Turmoil].

Whether customers will make use of such "nonbank banks" remains to be seen. A 1982 study of 2,362 consumer financial institution customers showed that although six out of ten held either a Sears or Penneys credit card, only one in five said they would obtain financial services from the department stores. Most believed "that stores should be stores and banks should be banks." See Survey, Customer Service Usage—Part I, The Unidex Report, May 1982, at 1-2 (publication of the Unidex Corporation).

9. The following table, based on Federal Reserve Board data, shows total lending outstanding in June 1983 by type of institution:

<table>
<thead>
<tr>
<th>Total Lending by Type of Monetary Institution</th>
<th>June 1983</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billions</td>
<td>Percent</td>
</tr>
<tr>
<td>Commercial Banksa</td>
<td>$1,074.6 63.1%</td>
</tr>
<tr>
<td>Savings and Loan Associations</td>
<td>472.1 27.7</td>
</tr>
<tr>
<td>Mutual Savings Banks</td>
<td>111.4 6.6</td>
</tr>
<tr>
<td>Credit Unions</td>
<td>44.9 2.6</td>
</tr>
<tr>
<td>Total</td>
<td>$1,703.0 100.0%</td>
</tr>
</tbody>
</table>

a. Exclusive of interbank loans. Based on "Last-Wednesday-of-Month" series. All other figures based on "end of period" data. See 69 FED. RESERVE BULL. A19, A30 (1983).

Of course, many of these loans are presently secured by real estate. See id. at A30. A depositary institution, or any other mortgagee, has no obligation under the common law to foreclose on such real property before pursuing other remedies, including the right to set-off against the borrower's deposit accounts. The mortgagee can bring an action on the debt, pursue its foreclosure reme-
The wide variety of deposit accounts now available and adaptable to the particular needs of individual consumers and businesses should continue to attract a substantial volume of deposits. Application of the general principles of article 9 to
this personal property would allow customers who keep a significant portion of their net worth in this form to hypothecate these valuable assets more efficiently in favor of lenders they prefer. Abolishing the doctrine of set-off would eliminate the advantages depositary institutions now enjoy over other lend-
ers when they extend credit to their own customers.\textsuperscript{12}

The trend toward national banking heightens the need for this reform.\textsuperscript{13} As depositary and other credit institutions increase their interstate activity, the nonuniformity of the current law will become more burdensome. Moreover, if the common law right to set-off is construed to reach a defaulting customer's deposit account in a branch or related institution in another state, the legal advantage that depositary creditors already enjoy will be augmented.\textsuperscript{14}

Section I of this Article shows how deposit accounts used as original collateral have functional attributes similar to more traditional collateral presently within the article 9 framework. The relationship between the proposed "new" article 9 security interest in such collateral and the contemporary right to set-off is then explored. Both permit the creditor, upon default, to foreclose extrajudicially on the debtor's chose in action against the depositary institution. The security interest, however, is consensual, whereas the common law right often arises by operation of law. Because the right to set-off no longer serves its historic function, and undermines fundamental article 9 policies, it should be expressly abolished. To the extent that depositary institutions need a unilateral, self-help remedy, they, like other creditors, can bargain with the debtor for an article 9 security interest.

Section II explains how the article 9 requirements for creation of a security interest, when supplemented with the lowest

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{12} See infra notes 50-53, and accompanying text. See generally infra text accompanying notes 108-278, 279-373, 374-440.

\item \textsuperscript{13} The Reagan administration favors the systematic removal of geographic restrictions on depositary institutions. See Regan Testimony, supra note 8, at 11-12. Recently, haphazard exceptions to federal and state barriers have multiplied. Citicorp and BankAmerica operate subsidiaries in every state. Numerous depositary institutions have out-of-state loan production offices and receive deposits from customers by mail. \textit{Id.} South Dakota has passed laws authorizing out-of-state bank holding companies to purchase state banks, and Citicorp has announced its intention to do so. See Financial Industry in Turmoil, supra note 8, at 1900-01; see also Volcker Statement, supra note 8, 69 FED. RESERVE BULL. 764-67.

\item \textsuperscript{14} It may be difficult to ascertain whether one bank that is affiliated with another is a "branch" bank. See generally Annot., 23 A.L.R.3d 683 (Supp. 1983). Courts look at a variety of factors, including the extent to which the new facility operates "independently" of the older, established bank, as evidenced by the extent to which the new bank depends on the older bank for capital and management services, whether there are interlocking boards of directors, whether the two facilities use the same bookkeeping and computer processing services, the extent of common ownership of stock, and differences in loan limits and interest rates at the two facilities. \textit{Id.}
\end{enumerate}
\end{footnotesize}
intermediate balance rule, would permit debtors and creditors to bargain effectively concerning the dimensions of any encumbrance against a deposit account. The requirements for the common law right to set-off, which can be satisfied by no creditor other than the depositary institution, are contrasted with the requirements of article 9. The advantages of the article 9 framework over the common law of security assignments and pledge are explained.

Section II also proposes that a creditor who retains the "new" article 9 security interest in deposit accounts should be subject to the Code's "public notice" requirements. Absent prompt filing, such a creditor, like other secured creditors, would risk subordination of its interest to later claimants seeking recovery from the same deposit account. Neither the common law of set-off nor the common law of assignments imposes similar notice obligations. Thus, the precise type of "secret lien" that article 9's perfection and priority rules attempt to eliminate survives in many modern banking transactions.

In section III, article 9's priority rules are applied to basic contests over deposit account collateral. Application of article 9 eliminates needless factual and legal uncertainty under the presently controlling statutory and case law. As shown in section IV, contests over deposit account collateral under the Federal Tax Lien Act and the Bankruptcy Reform Act also would be more easily and fairly resolved if this recommendation were enacted. The benefits of bringing deposit account financing under the article 9 "umbrella" carry forward into these important federal commercial statutes.

Finally, section V explores how article 9's default provisions would affect the rights of creditors and debtors in transactions secured by deposit account collateral. A specific proposal for supplemental protection of the consumer debtor-debtor is suggested.

15. See infra notes 177-79 and accompanying text.
16. See infra text accompanying notes 237-78. Subsequent creditors, unaware of the depositary institution's inchoate right to set-off against the deposit account, or of an earlier security assignment, may extend credit to the debtor on terms that do not adequately reflect their greater risk should the debtor default.
I. CONCEPTUAL AND HISTORICAL REASONS FOR INCLUDING SECURITY INTERESTS IN DEPOSIT ACCOUNTS IN ARTICLE 9 AND FOR DISPLACING THE COMMON LAW

Prior to the enactment of the Uniform Commercial Code, personal property law was not simple, uniform, or adequate. The law of each state validated a variety of security devices, each applicable to a different class of personal property. Within a given jurisdiction, the formal rules governing the creation of each device, the rights of the secured party on default, and the creditor's obligation to give notice of its interest to other creditors or purchasers of the encumbered property all varied with the categorization of the personal property. Different priority rules then had to be applied to resolve disputes among creditors competing for the same collateral. This intra-state complexity was exacerbated by variations among states. Not surprisingly, this tangle of rules and formalities did not meet the needs of twentieth century lenders and borrowers for a system in which all types of personal property could be efficiently hypothecated.19

Article 9 was intended to correct that situation by creating an integrated and uniform law applicable to security interests in personal property. As explained by its sponsors, article 9 was to provide "a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward."20 Security interests in deposit accounts as original collateral, however, are excluded from article 9's scope.21 Presently, the use of deposit accounts as collateral for credit is governed by three separate bodies of common law, modified by scattered state statutes: security assignment,22

20. U.C.C. § 9-101 comment; see also id. § 9-102 comment.
21. Id. § 9-104(f); see also supra note 2 and accompanying text.
22. See, e.g., infra notes 129, 130, 134-35, 147-53, 191, 186, 188-95, 197, 201, 207-08, 248-49, 300-07, 343-47, and accompanying text; see also Restatement (Second) of Contracts §§ 316-343 (1979) statutory note (compiling state statutes) ("Statutes or rules of court in most States require an action to be prosecuted in the name of the real party in interest, as does Rule 17(a) of the Federal Rules of Civil Procedure. In addition most states have statutes providing for set-offs and other defenses against an assignee, and a number of States have statutes relating to other aspects of the assignment of contractual rights."). California and Hawaii have amended article 9, as proposed here, to cover security interests in deposit accounts as original collateral. See Cal. Com. Code § 9104 (West 1964); Hawa\ii Rev. Stat. § 490-8-104 (1976). These states,
pledge, and set-off. Although the historical background and conceptualization of these common law security devices are quite different, all three serve the same function as would the proposed "new" article 9 security interest in modern banking transactions. Each permits the benefited creditor to establish its priority vis-à-vis other claimants and to foreclose on the borrower's deposit account in the event of default without seeking a court judgment or other judicial process.

Article 9's coverage should be expanded to include security interests retained in deposit accounts as original collateral. Under this proposal, article 9 would become the primary source of law governing deposit account financing arrangements. The creation of a workable article 9 security interest in deposit ac-

however, have neither enacted this Article's other modifications of article 9 nor abolished the common law right to set-off. See, e.g., infra notes 72, 250, and accompanying text.


25. The Uniform Commercial Code's definition of "depository account," stated in § 9-105(1)(e), is adopted for purposes of this Article, see supra note 2. That definition expressly excludes "an account evidenced by a certificate of deposit." See U.C.C. § 9-105(1)(e).

Professor Harris has argued that a "non-negotiable certificate of deposit" should be categorized as a "certificate of deposit" so that it would fall within article 9's coverage. See Harris, Non-Negotiable Certificates of Deposit, 29 U.C.L.A. L. Rev. 330 (1981). Under this recommendation, all forms of "deposit account" collateral would be covered by article 9, eliminating the need to distinguish the many, constantly changing new types of accounts. Article 9's rules governing negotiable certificates of deposit would, however, remain unchanged. See infra note 262.
counts, combined with abolition of the right to set-off and dis-
placement of the common law of security assignments and
pledge, would further the reform effected by the present ver-
sion of article 9. Deposit accounts would no longer receive un-
warranted special treatment within states and would be more
uniformly treated among states. Moreover, debtors and all
creditors, whether depositary or nondepositary institutions,
could make more effective use of these valuable assets as col-
lateral for extensions of credit.

In order to ascertain the appropriateness of this recom-
mendation from a conceptual and historical perspective, two
basic questions must be answered. First, is the expansion of
article 9 to cover deposit account collateral consistent with the
Code's formulation of what constitutes a security interest in
personal property? Second, assuming the enactment of a uni-
form article 9 procedure for asserting rights in deposit ac-
counts, does any independent reason remain for preserving
banks' common law right to set-off?

A. A “New” Article 9 Security Interest in Depos-
It Accounts as Original Collateral

Every day, banks enter into consensual financing arrange-
ments with their consumer and business depositors that would
be covered by article 9's comprehensive, functional defini-
tion of a security interest, but for section 9-104(l)'s express exclusion
of the “transfer of an interest in any deposit

26. U.C.C. § 9-104(l); see supra note 2. A creditor may retain a security in-
terest in a deposit account in either of two ways. The deposit account might
serve as the original “back-up” for the loan. Alternatively, the security interest
might first attach to some other type of property, and upon sale of that encum-
bered property the depositor would receive cash or other proceeds which then
would be deposited in the deposit account. In this Article, the first arrange-
ment is described as a security interest in a deposit account as original collat-
eral. The second is referred to as a security interest in proceeds in a deposit
account.

The exclusion in § 9-104(l) does not extend to security interests in pro-
ceeds in a deposit account, see U.C.C. § 9-306, or to priorities in proceeds, see id.
§ 9-312.

27. The official comment to § 9-101 explains:

Under this Article the traditional distinctions among security de-
VICES, based largely on form, are not retained; . . . the single term “se-
curity interest” substitutes for the variety of descriptive terms which
secured party, normally a promise to pay money. Second, the secured party must have a conditional interest in personal property wholly or partially owned by the debtor. The condition enabling the secured party to take action against the personal property is the debtor's default on its obligation to pay. Third, the transaction creating the secured party's conditional interest in property must be consensual.

A bank loan expressly secured by deposit account collateral shares these functional attributes. Suppose a bank loans $100,000 to a business customer and requires that the customer maintain a compensating balance in its demand account in the bank in the amount of twenty percent of the debt outstanding on any given day, or that the customer assign or pledge a non-negotiable certificate of deposit issued by the depositary institution with a face value of $20,000. Clearly, the debtor has an obligation to the bank to repay money—the $100,000. Moreover, the security arrangement is consensual.

had grown up at common law and under a hundred-year accretion of statutes.

Under this Article distinctions based on form... are no longer controlling. For some purposes there are distinctions based on the type of property which constitutes the collateral... The scheme of the Article is to make distinctions, where distinctions are necessary, along functional rather than formal lines.

Id. § 9-101 comment (emphasis added).

28. See id. § 1-201(37), which provides in pertinent part: "'Security interest' means an interest in personal property... which secures payment... of an obligation."

29. See id. U.C.C. § 9-203(1) (c) provides that a security interest is "not enforceable... unless the debtor has rights in the collateral." Section 9-501(1) gives the secured party certain rights and remedies when the debtor "is in default under a security agreement."

30. Article 9's scope provision states: "This Article applies to security interests created by contract... This Article does not apply to statutory liens..." Id. § 9-102(2) (emphasis added). Certain common law and statutory liens are expressly excluded from article 9's coverage. See, e.g., id. § 9-104(b), (c).

31. The discussion in the accompanying text focuses on bank loans where the debtor agrees in the note or loan agreement that the deposit account is collateral. The debtor's manifestation of consent may take many different forms. The terms of the loan may require that the debtor maintain a specified minimum balance in its deposit account. The debtor may execute a written assignment of its interest in the deposit account and deliver that document along with a symbolic writing or certificate to the lender. See, e.g., Kaw Valley State Bank & Trust v. Commercial Bank of Liberty, 557 S.W.2d 710, 712 (Mo. 1978). Alternatively, the debtor may agree that the bank has the right to set-off against whatever balance remains in the account upon default. As explained in a subsequent section, a right to set-off operates upon default in a manner similar to a security interest. See infra text accompanying notes 68-107.

Under the common law, the depositor need not agree to grant the bank the right to set-off, the right arises by operation of law. See infra notes 70-71.
But does the bank have a conditional interest in personal property owned by the debtor? When a customer deposits money in a bank, title to the funds passes to the bank and a debtor-creditor relationship is established. In this example, upon deposit of the $20,000 in the demand account or purchase of the time certificate the bank becomes the owner of the money and the depositor has a contractual right to receive payment from the bank of the $20,000, either on demand or after a fixed period of time. The personal property owned by the depositor is the contractual right to receive payment from the bank. This right to receive payment, already "earned" by the depositor's transfer of funds to the bank, is subject to the bank's conditional interest and would be classified if covered by article 9 as a "general intangible." 

Although a deposit account thus falls within article 9's def-
inition of "personal property," it nonetheless may seem to be a quite different, less valuable, and more uncertain form of collateral than that envisioned by article 9's drafters. But closer scrutiny confirms what the commercial practices of banks plainly suggest—that deposit accounts today provide useful additional collateral. Indeed, with the trend toward national banking, the proliferation of different types of deposit accounts, and the increasing popularity of one-stop financial service centers, the importance of this asset is likely to increase.

The first apparent conceptual difficulty with deposit account collateral is that in some deposit account financing arrangements the "account debtor," the entity obligated to pay on the general intangible, is the same entity as the "secured party" in the transaction. For instance, in the earlier example, where the depositary bank both made the $100,000 loan and retained a security interest in the $20,000 compensating balance or in its own savings certificate, the bank was both "secured party" and "account debtor."

Article 9, however, recognizes that a single entity may perform both roles. The only form of deposit account presently included within article 9 is a negotiable certificate of deposit. Like the excluded forms of deposit accounts, a negotiable certificate of deposit represents the bank's promise to repay its depositor. A bank may retain an article 9 security interest in its own negotiable certificate of deposit. Upon the customer's de-

34. See infra notes 50-53 and accompanying text.
35. The official comment to U.C.C. § 9-101 explains that Code sponsors intended that "[t]he Article's flexibility and simplified formalities" would allow "new forms of secured financing" to fall within its scope. Banks' substantial involvement in installment lending to consumers and small businesses is a recent phenomenon. See Kripke, Reflections of a Drafter, 43 Ohio St. L.J. 577, 577 (1982). Currently, banks are actively seeking out such borrowers due to increased deposits attracted by new types of accounts. See supra notes 6-10 and accompanying text.
36. See U.C.C. § 9-105(1)(a) ("Account debtor"), (m) ("Secured party"). As explained in the accompanying text, this difficulty has needlessly troubled commentators. See, e.g., Comment, Banking Set-Off: A Study in Commercial Obsolescence, 23 Hastings L.J. 1585, 1586-87 (1972).
37. See U.C.C. § 9-105(1)(e), which excludes a certificate of deposit from the definition of "deposit account." A certificate of deposit is an "instrument" within article 9 if it satisfies article 3's formal requisites of "negotiability." See id. §§ 3-104, 9-105(1). U.C.C. § 9-102(1)(a) provides that article 9, subject to the § 9-104 exclusions, applies "to any transaction . . . which is intended to create a security interest in . . . instruments."
38. U.C.C. § 9-104(2)(c) defines a negotiable certificate of deposit as "an acknowledgment by a bank of receipt of money with an engagement to repay it."
39. There is no language in article 9 excluding instruments where a single entity is both secured party and issuer.
fault, section 9-502 allows the bank to collect directly from the account debtor.\textsuperscript{40} In other words, the bank in its role as secured party can extrajudicially “collect” from itself as borrower by cancelling its obligation under the deposit agreement to repay the defaulting depositor. If this Article’s recommendation were adopted, banks could enter into the same kind of financing transaction secured by any form of deposit account of their customers. Outside creditors also could bargain with the debtor for a security interest in the deposit account as original collateral.\textsuperscript{41} Like a creditor who retains a security interest in a negotiable certificate of deposit issued by another institution, the secured creditor would collect in the event of default from the third party obligor—the depositary bank.

The second apparent conceptual difficulty stems from a more practical distinction, that deposit accounts seem more susceptible to fluctuations in value due to the depositor’s control and dominion than do other forms of personal property covered by article 9. When checks are presented and finally paid, or when the depositor withdraws funds, there is a reduction in the value of its right to receive payment from the bank, which is the original collateral securing the loan.

But it was resolved even prior to the Code that a creditor does not lose its secured status by permitting the debtor to retain control over collateral during the loan repayment period. The Code’s approach also leaves business judgments about the value of any particular type of collateral to the secured party. For example, despite the “precariousness” of nonnotification nonrecourse accounts receivable financing, article 9 validates such transactions and provides the “high risk” accounts financier with relatively clear rules concerning the creation and perfection of its security interest, as well as its priority vis-à-vis other creditors.\textsuperscript{42}

A comparison of the risks of nonnotification nonrecourse

\textsuperscript{40} U.C.C.\textsection 9-502 provides in pertinent part:

When so agreed and in any event on default the secured party is entitled to notify an account debtor or the obligor on an instrument to make payment to him . . . .

. . . If the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency.

\textit{Id.} \textsection 9-502(1), (2).

\textsuperscript{41} See infra text accompanying notes 108-70.

\textsuperscript{42} The history of accounts receivable financing provides a useful analogue supporting this Article’s proposal. Professor Gilmore recounts that from the sixteenth to the eighteenth century it was believed that an interest in a chose in action could not be conveyed. See 1 G. GILMORE, supra note 10, \textsection 7.3. But
accounts receivable financing with the risks of deposit account financing reveals that some creditors may prefer deposit account financing. If the collateral is accounts receivable and the account debtors do not pay and are judgment-proof, the collateral is worthless—there is no recourse against the principal debtor. Moreover, if the principal debtor does not complete performance of its obligations to the account debtors, the account debtors have no obligation to pay the secured creditor.\(^4\)

This form of financing exposes the secured party to a substantial risk of fraud: the principal debtor may not remit all proceeds collected to the secured party, it may exaggerate the amount of its account, it may create wholly fictitious accounts, or it may hypothecate only questionable accounts.\(^4\)

during the nineteenth century, English decisions began to validate such assignments, characterizing the assignee's interests as "equitable". Id.

The law governing accounts receivable financing in this country also was judge-made until the 1940s. Id. § 8.1. In the seminal case of Benedict v. Ratner, 268 U.S. 353 (1925), the Supreme Court held that nonnotification accounts receivable financing was "fraudulent" because of the principal debtor's continued dominion over the accounts. Id. at 360-61. Following the Great Depression, however, as accounts receivable financing became more important and prevalent, lenders attempted to get around the Benedict rule by devising arrangements which appeared to require creditor supervision of the debtor's use of the accounts. 1 G. Gilmore, supra note 19, § 8.3; Gilmore, Security Law, Formalism and Article 9, 47 Neb. L. Rev. 659, 667 (1968).

Dissatisfaction with the post-Benedict case-by-case resolution of accounts receivable issues led states during the 1940s and early 1950s to enact laws sanctioning these arrangements. 1 G. Gilmore, supra note 19, § 8.6. Although a few of the early statutes merely validated the common law right to assign such interests, most statutes required the secured party to give public notice of its interest. Id. § 8.7.

This pattern was followed in article 9. The Code validates nonnotification nonrecourse accounts receivable arrangements, but the secured creditor must give public notice of its interest to obtain the status of a creditor with a perfected security interest. See U.C.C. §§ 9-205, -302, -304, -305. Without such status, the creditor will lose to other creditors both in and out of bankruptcy. See id. §§ 9-301(1)(b), (3), 9-312; 11 U.S.C. § 544(a)(1) (1982).

If this Article's proposal were implemented, the development of deposit account collateral would parallel this history of accounts receivable financing. The common law right to set-off is in many respects the functional equivalent of a security interest in a deposit account. More traditional consensual liens against deposit accounts are governed by the common law of pledge and assignments. The recommendation here is to create a statutory right that would displace the common law. The codification of such a right would require that the depositary institution give public notice of its interest. See infra text accompanying notes 237-78, 396-440.

43. U.C.C. § 9-318(1)(a) provides that absent an enforceable waiver of defense clause "the rights of an assignee [the secured creditor] are subject to . . . all the terms of the contract between the account debtor and assignor [the principal debtor] and any defense or claim arising therefrom."

With deposit account financing, on the other hand, the account debtor—a licensed depositary institution—can be expected, absent insolvency, to repay its obligation under the deposit agreement. To enter the credit business, the depositary institution had to establish a minimum level of capital, expertise, and overall creditworthiness to provide assurance that it would meet its debts. Its commercial success may depend on its public image for security and reliability. Moreover, with respect to certain types of deposit accounts, there may be significant legal or contractual limits on depositor withdrawals.

For example, if the collateral is a three and one-half year nonnegotiable, nontransferable savings certificate, there is less danger of dissipation than in the case where the depositor is left in possession of a comparable negotiable certificate of deposit. The depositor may have no right to withdraw the $10,000 in the nonnegotiable certificate before the maturity date, or partial withdrawal may be prohibited, or early withdrawal may cost the depositor six months' simple interest, even if forfeit of that amount reduces the $10,000 principal. Yet article 9 covers the latter but not the former.

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45. See supra note 10 (describing different types of deposit account collateral).

46. The “terms and agreements” of the institution issuing the nonnegotiable certificate of deposit may specify that it is “non-assignable (except on the Books of the Bank), non-negotiable, [and] non-transferable.” See Terms and Agreements, First American Bank, N.A., Wash., D.C., at 6-7 (Oct. 1983). Under the common law of assignments, contract terms expressly prohibiting assignments of rights, even though narrowly construed, can render a purported transfer ineffective. In the more usual case, the contract terms are construed to give the obligor (the depositary bank) a right to damages against the assignor (the depositor) but the assignment is effective. See RESTATEMENT (SECOND) OF CONTRACTS § 322(2) (b) (1979). The Uniform Commercial Code goes further and renders all such antiassignment terms ineffective. See U.C.C. § 9-318(4).

Even where the assignment is effective, the nonnegotiable instrument is more difficult to transfer because the assignee will not obtain holder in due course status. See 1 G. GILMORE, supra note 19, § 7.8, at 211. Accordingly, the contract right acquired by the assignee (the purchaser of the nonnegotiable instrument) is subject to any defenses or claims that the obligor (the issuer of the nonnegotiable instrument) could raise against the assignor (the depositor). See U.C.C. § 9-318(1); RESTATEMENT (SECOND) OF CONTRACTS § 336 (1979). A holder in due course of a negotiable instrument takes free of such claims and defenses. See U.C.C. §§ 3-302, -305, 9-309.

47. In August of 1983, the Depository Institutions Deregulation Committee (DIDC) eliminated interest rate ceilings on time deposits with a maturity of more than 31 days. 48 Fed. Reg. 38,455-57 (1983) (to be codified at 12 C.F.R. § 1204.123). In addition, the committee removed interest rate ceilings on time deposits of $2,500 or more with notice periods of 7 to 31 days, id., and reduced the minimum early withdrawal penalty for the deposit account described in the
The risk of fluctuation in value, of course, is greater with demand accounts than with certificates of deposit. But the popular interest-bearing checking accounts require, by law and contract, maintenance of sizeable average monthly balances.\(^4\)

In addition, the secured party and the depositor could negotiate an individualized agreement circumscribing the depositor's ability to draw down the account. The secured creditor, when not also the depositary institution, could require, as a term of the loan, that the debtor obtain the depositary institution's promise to abide by the special agreement. Finally, the depositor, for its own business reasons, may need a sizeable general account to handle daily receipts and disbursements.\(^4\)

Deposit account collateral is preferable in certain respects to some forms of tangible collateral. Difficult valuation problems can be avoided as depreciation and obsolescence need not be considered. In the event of default, foreclosure on a deposit account is less costly than foreclosure on tangible collateral. Particularly where the lender is the depositary institution, modern banking records of daily account activity facilitate

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48. The DIDC voted in October 1983 to eliminate the $2,500 minimum balance on money market deposit and SuperNOW accounts by January 1, 1986. Wash. Post, supra note 47, at 29, col. 3. But banks and thrift institutions may continue minimum balance requirements. Today, some depositary institutions insist on a $5,000 minimum balance, although the legal requirement is only $2,500. See id.

49. Federal Reserve Board money stock figures show that of approximately $2,100 billion in demand deposits, other checkable deposits, and savings and time deposits held in all depositary institutions, approximately 16.8% is in checkable demand deposits and another 17.4% is in money market deposit accounts permitting limited check transfers. See supra note 6.

A Federal Reserve survey estimates that in June 1983 there were $289.5 billion of demand deposits (in commercial banks) owned by individuals, partnerships, and corporations. Nonfinancial businesses owned approximately 51% ($147.7 billion), consumers owned 30% ($86.9 billion), and financial businesses, foreign individuals, and foreign partnerships or corporations owned the remainder. 69 Fed. Reserve Bull. A 25 (1983).
inexpensive monitoring of the depositor's compliance with consensual or legal restrictions on depletion of the account.

These observations are consistent with actual banking practices. Borrowers who maintain deposit accounts in the bank can obtain car loans at lower rates. The bank relies on both the car and the deposit account as collateral. Bankers, testifying before Congress in 1976 to urge their right to set-off in bankruptcy proceedings, explained that the right to set-off is taken into consideration when a loan is negotiated, particularly when the potential borrower is "second tier" or "high risk"; that the right to set-off is reflected in the cost of capital; and that banks assume they will have a continuing relationship with these customers. A 1972 survey of one hundred banks in the Eleventh Federal Reserve District showed that "nearly 60% require compensating balances on some types of loans," that large banks have required such balances since before 1950, and that there is an increasing trend among small banks to do so. Two-thirds of the banks surveyed allowed their customers to use either time or demand deposits to meet the collateral requirements. The Comptroller of the Currency recently promulgated regulations creating an exception to national bank lending limits for extensions of credit in cases where the lending bank has been assigned segregated deposit accounts as

50. For example, in November 1983 First American Bank, N.A., in Washington, D.C., offered automobile loans to its customers at one percent below its normal rate if the customer agreed to an automatic debit of the monthly loan repayments from a deposit account maintained at the bank.

51. See A Capital Markets Analysis of Proposed Changes to the Bankruptcy Act—the Impact on Commercial Bank Lending: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., 2d Sess. 2494, 2499, 2502, 2505, 2507, 2508 (1976) for the statement of John W. Ingraham, Vice-President and Senior Officer, Citibank, N.A., New York, N.Y. Mr. Ingraham represented the Robert Morris Associates Task Force, an association of 6000 bank loan and credit officers who in turn represent about 1650 banks holding 78% of the United States's commercial banking resources. See id. at 2484, 2497; see also Committee on Developments in Business Financing (ABA), Structuring and Documenting Business Financing Transactions under the Federal Bankruptcy Code of 1978, 35 Bus. Law. 1645, 1688-91 (1980) (Many institutional lenders require borrowers to maintain cash deposits with the institution during the loan repayment period—in part to help meet the institution's reserve requirements, in part as a pricing mechanism, and in part to provide security for the loan by way of set-off or through an assignment of an interest in the accounts.); Mackara, The ABC's of the Prime Rate, MONTHLY REV. FED. RESERVE BANK ATLANTA, July 1974, at 100-05 (describing use of compensating balance requirements to establish effective lending rates).


53. See id.
collateral.\textsuperscript{54}

Why then does article 9 exclude security interests in deposit account collateral despite their functional similarity to other financing transactions that are covered? The cryptic official comment to section 9-104 recognizes that deposit accounts "are often put up as collateral."\textsuperscript{55} But it goes on to state that "[s]uch transactions are often quite special [and] do not fit easily under a general commercial statute."\textsuperscript{56}

When compared with other article 9 secured transactions, however, deposit account financing ceases to appear so special. Rather, deposit financing fits more easily into the Code's definition of a security interest in personal property than do other arrangements, such as sales of accounts, that are forced into the article 9 framework.\textsuperscript{57} The considerations that justify bringing outright sales of accounts under the article 9 "umbrella" sug-

\begin{footnotesize}
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\item \textsuperscript{54} See National Bank Lending Limits, 48 Fed. Reg. 15,844, 15,849, 15,856 (1983). To qualify for the exception the bank must take whatever steps are required under non-Code law to obtain a security assignment of the bank account, but it may not rely on its right to set-off. \textit{Id.} at 15,849.
\item \textsuperscript{55} U.C.C. § 9-104 comment 7 (emphasis added).
\item \textsuperscript{56} \textit{Id.} A subsequent law review article by Professors Kripke and Coogan, both participants in the drafting of article 9, suggested without elaboration that security interests in deposit accounts as original collateral should not have been excluded from the Code. \textit{See} Coogan, Kripke & Weiss, The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements, 79 HARV. L. REV. 229, 265 (1965).
\item \textsuperscript{57} In an outright sale of accounts, the principal debtor has no remaining obligation to pay the secured creditor, and the secured party has complete title to the personal property rather than a conditional property interest in it. Nonetheless, U.C.C. § 9-102(1)(a) expressly covers sales of accounts. \textit{See} U.C.C. § 9-102(1)(a) comment 2.
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gest additional policy reasons for coverage of deposit account collateral. Both arrangements are commercially important and create risks of "secret liens."58

The official comment to section 9-104 also proclaims that loans secured by bank accounts are "adequately covered by existing law."59 This statement is not accurate.60 Moreover, as another commentator has suggested in an analogous context, even if the non-Code law were "adequate," whatever that means, bringing these transactions into the article 9 framework would simplify, clarify, and make more uniform the law of secured transactions.61

The history of the exclusion of demand accounts from the Code is slightly more illuminating than is the laconic official comment. Beginning with the 1955 supplement to the 1952 official draft of article 9,62 the Code sponsors expressly excluded both bank deposit accounts and the banks' right to set-off against such accounts.63 Professor Gilmore has stated that banking groups were responsible for the exclusion of the right to set-off,64 another commentator has surmised that they also may have been the force behind the deposit account exclusion.65

Professor Gilmore explains:
This exclusion [of the right to set-off] is an apt example of the absurdities which result when draftsmen attempt to appease critics by putting into a statute something that is not in any sense wicked but is hopelessly irrelevant. Of course a right of set-off is not a security interest and has never been confused with one: the statute might as appropriately exclude fan dancing. A bank's right of set-off against a depositor's account is often loosely referred to as a "banker's lien," but the "lien" usage has never led anyone to think that the bank held a security interest in the bank account. Banking groups were, however, concerned lest someone, someday, might think that a bank's right of set-off, because it was called a lien, was a security interest. Hence the exclusion, which does no harm except to the dignity and self-respect of

and Ownership: An Examination of the Scope of Article 9, 35 Stan. L. Rev. 175 (1983).
58. See infra text accompanying notes 237-78.
59. U.C.C. § 9-104 comment 7.
60. See infra text accompanying notes 279-373 (discussing priority battles among assignees and competing claimants for deposit accounts).
61. See Harris, supra note 25, at 390-61.
63. See U.C.C. §§ 9-104(i), (j) (1955).
64. See 1 G. Gilmore, supra note 19, § 10.7, at 315-16.
65. See Harris, supra note 25, at 362.
This Article vindicates the banking groups' concern as Gilmore reports it. The conceptual and historical distinctions among the banker's lien, the right to set-off, non-Code security assignments of interests in bank accounts, the pledge, and an article 9 security interest in a deposit account as original collateral are neither "confused" nor "ignored." Instead, if article 9 were expanded and displaced the common law of security assignments and pledge, banks and other creditors would be better able to create consensual security interests in deposit accounts. There would no longer be any need to preserve the banks' right to set-off, which arises by operation of law. Moreover, because of the functional similarity between a security interest (whether created by assignment, pledge, or under article 9 as proposed) and a right to set-off, the continued existence of the common law doctrine of set-off would undermine the purposes of article 9 and unacceptably favor depositary institutions over other creditors.

Having concluded that there are historical, conceptual, and practical reasons for including consensual arrangements involving deposit account collateral in article 9, the relationship between a security interest in such collateral and the bank's right to set-off must now be explored.

B. THE BANK'S RIGHT TO SET-OFF

The equitable doctrine of set-off provides that parties who are "mutually indebted" to each other can extinguish their cross-demands. In the credit context, the depositary institution is a "borrower" with respect to the funds deposited and a "creditor" with respect to the advance given its customer. The customer is a "creditor" with respect to the deposit made and a "borrower" with respect to the loan received. If the customer defaults, it may be unfair to require the depositary institution to repay its obligation in full, particularly if the customer is in difficult financial straits and likely to be insolvent before the

66. 1 G. Gilmore, supra note 19, § 10.7, at 315-16.

67. The banker's lien arises by operation of law. Unlike either the right to set-off or this Article's proposed security interest, the banker's lien is a charge against all tangible and quasi-tangible property of the customer in the bank's possession such as securities or commercial paper. The banker's lien does not attach to the customer's chose in action against the bank arising out of the deposit agreement. See Note, Banking Setoff: A Study in Commercial Obsolescence, 23 Hastings L.J. 1585, 1586-87 & nn.8-10 (1972); see also 5A Michie, supra note 32, § 165.

68. See infra notes 159-66 and accompanying text.
depositary institution can prosecute a separate action on the debt. Under the common law notion “that a man should not be compelled to pay one moment what he will be entitled to recover back the next,” the depositary institution can, without a court order or customer consent, reduce unilaterally its obligation under the deposit agreement by the amount of the repayment it should have received but did not.

From a functional standpoint, the most important difference between an article 9 security interest and the right to set-off is that the former is consensual while the latter usually arises by operation of law. Foreclosure on an article 9 security interest in a deposit account, like set-off, would provide the creditor with a prejudgment, self-help remedy against the depositor’s chose in action.

If article 9 were expanded to cover security interests in deposit accounts as original collateral, displacing the common law of assignments and pledge, what should become of the common law right to set-off? Lenders could be allowed both to create a consensual security interest by using article 9 and retain the common law right to set-off, enjoying all the rights and remedies afforded by the Code and by the common law. Alternatively, lenders could be put to an election: if they create an article 9 security interest, they waive their common law right. Or, as is recommended here, the Code could provide expressly that its coverage in article 9 of security interests in deposit accounts as original collateral displaces altogether the right to

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71. See id. at 40; Murray, Banks Versus Creditors of Their Customers: Set-Offs Against Customers’ Accounts, 82 Com. L.J. 449, 449-50 (1977); Note, supra note 67, at 1587-88. But see supra note 31.
72. Such cumulative remedies are permitted under the present law, as long as the depositary institution does not obtain more than a single satisfaction of the debt. For example, if its customer pledges a deposit account as collateral or executes an assignment of such deposit account in favor of the depositary institution, on the customer’s default, the bank can set-off or foreclose. See infra note 452 and accompanying text. Similarly, where the depositary institution retains an article 9 security interest in its own negotiable certificate of deposit, it can either foreclose under article 9 or exercise its common law right to set-off. See U.C.C. §§ 9-501(1), -502.

In California, which permits the retention of an article 9 security interest in all deposit accounts, depositary institutions also may assert an extrajudicial right to set-off. See CAL. CIV. CODE § 3054 (West 1974); CAL. CIV. PROC. CODE § 431.70 (West 1978); see also Gonsalves v. Bank of Am., 16 Cal. 2d 169, 173, 105 P.2d 118, 121 (1940); Arnold v. San Ramon Valley Bank, 184 Cal. 632, 636, 194 P. 1012, 1013 (1921). This Article proposes a more substantial revision of the law.
set-off in modern credit transactions.\textsuperscript{73}

1. The History of the Right to Set-Off

Before concluding that the common law right to set-off should be displaced, one must examine its origin and subsequent history to ascertain whether any policy favors its preservation in the context of modern banking transactions. The right to extrajudicial and nonconsensual set-off originated in Roman law. The notion that one of two mutually indebted parties can unilaterally extinguish cross-demands in advance of trial developed in response to jurisdictional and procedural problems that no longer exist—namely, the inability of parties to join counterclaims before courts.\textsuperscript{74} Modern rules of civil procedure now permit such joinder. If creditors for other reasons want the power to foreclose unilaterally on deposit accounts in advance of trial, they should be required to bargain with their debtors for such rights. Substitution of the article 9 framework for the common law right of automatic set-off would accomplish that result.

To understand the origins of the common law doctrine, consider the plight of a depositary lender in Rome in 350 B.C. that has no right to set-off. A depositor that has borrowed funds defaults and the lender refuses to repay the deposit. If the depositor brings an action on the deposit agreement, the lender cannot raise the question of the depositor's default in the same case; accordingly, the depositor would win. Although the lender may not owe anything when the reciprocal debts are netted, it must bring a subsequent action to recover the amount it would not have been ordered to pay had a procedure existed for joining counterclaims. In the meantime, the depositor would enjoy the award from the first action.

Extrajudicial, nonconsensual set-off prevents the depositor from thus recovering on the chose in action against the lender without simultaneously answering for the depositor's own breach of the separate loan agreement. The lender unilaterally extinguishes its obligation to repay the deposit before the depositor even sues on the deposit agreement.\textsuperscript{75}

\textsuperscript{73} A new Code section or an official comment could state explicitly that the right to set-off was abolished. See U.C.C. § 1-103.

\textsuperscript{74} Comment, supra note 3, at 227.

\textsuperscript{75} See id. at 226-28.

As explained below and in subsequent sections of this Article, banks have advantages over secured and general creditors by virtue of the common law right to set-off. But in Roman times, the right to set-off was used to limit banks'
Under modern rules of civil procedure, if the depositor sues, the bank can join its cause of action on the loan as a counterclaim. Then the court will supervise the set-off; both parties will have notice and an opportunity to be heard on each of their contractual claims. Yet the common law right to set-off anomalously continues to coexist with these now adequate procedures for judicial resolution of all matters between two parties. This result is possibly attributable to nothing other than inertia and historical accident.

But there is another equally plausible explanation. The right to set-off is a powerful prejudgment self-help remedy. Although its historic purpose was to aid parties who were "shut out" of the judicial process, it is defended vigorously today by creditors who, with good reason, believe it is in their best legal and business interests to avoid going to court.

When a bank asserts its common law right, it simply halts performance under the deposit agreement without notice to the depositor or judicial hearing—refusing to honor the depositor's checks or withdrawal requests. Only if the depositor later brings an action and establishes that there was no default on the loan will the bank be penalized. By contrast, if both claims required judicial resolution, the bank would immediately lose control of the deposit account. At best, by application to the

rights. Id. at 230, 234, 276 n.312. If a bank sued its depositor for defaulting on a loan and failed to set-off the amount it owed the depositor under the deposit agreement, it could lose its entire claim because of the overstatement. See Loyd, supra note 69, at 542.

Automatic extinction of cross-demands helped maintain a system of feudal justice in northern France during the thirteenth century. Lords would not tolerate the adjudication of claims concerning their land or vassals in the courts of other lords as counterclaims. Automatic extinction avoided direct confrontation while permitting consideration of both transactions. Comment, supra note 3, at 235-41. In contrast, procedures in the ecclesiastical courts, which did not have such jurisdictional problems, were similar to modern procedures governing counterclaims; the secular courts permitted only judicially supervised set-off, both claims were heard in a single proceeding, and the judge rendered a single judgment. Id. at 242-44.

77. For example, in 1851 a California statute was enacted that included a provision subsequently interpreted to permit extrajudicial nonconsensual set-off. See Comment, supra note 3, at 258-64. The same statute also established liberalized rules of civil procedure permitting joinder of counterclaims. It is not clear whether David Dudley Field, who worked on an earlier version of the statute, intended this result. See id. at 252-57. In California today a bank can rely on its equitable right to set-off, can create and enforce an article 9 security interest, or can join its counterclaim when sued by the depositor on the deposit agreement. See supra note 72; sources cited supra note 44; see also Cal. Civ. Proc. Code §§ 427.10, 428.10-.30, .80 (West 1973) (permissive rules on joinder of "crosscomplaints").
court and following notice to the depositor and a hearing, the bank might obtain prejudgment provisional relief. Until entry of final judgment, however, the court, not the bank, would control the deposit account and would adopt measures preventing dissipation by either party.

Others have urged that, given concerns about procedural due process and the demise of restrictive rules of civil procedure, extrajudicial foreclosure on deposit accounts should be forbidden altogether. The proposal here is less draconian. By substituting article 9 rights and remedies for the common law right to set-off, creditors could still extinguish cross-demands in deposit accounts without going to court, but only with express advance consent from the debtor in the form of a written grant of a security interest in the deposit account or by delivery of an “indispensable instrument.” Congress adopted a similar


79. The states have their own individualized procedures for prejudgment attachment or garnishment. Here the bank—by asking the court to sanction a “freeze” of the depositor’s bank account pending trial on the counterclaim—would in effect be seeking attachment of the depositor’s right, based on the deposit agreement, to repayment on demand. As with other more conventional forms of attachment, the bank would have to file a bond and establish by affidavit a statutorily specified substantive ground. For example, the bank might be able to show that its claim is for breach of a loan contract and that the depositor is unlikely to have a meritorious defense. See D.Epstein & J. Landers, Debtors and Creditors: Cases and Materials 3-8 (2d ed. 1982).


82. See, e.g., Note, supra note 67. New York prohibits set-off against deposit accounts containing direct deposits of social security or “supplemental security income” payments. N.Y. Banking Law § 9-g (McKinney Supp. 1983).

83. See U.C.C. § 9-203(1)(a); see also infra notes 109-12 and accompanying text. This approach is consistent with the early common law and chancery practice in England; set-off was permitted under judicial supervision or extrajudicially where there was an accord between “mutually indebted” parties. Comment, supra note 3, at 248-52.

84. The Restatement of Security defines “indispensable instrument” as “the formal written evidence of an interest in intangibles, so representing the intangible that the enjoyment, transfer or enforcement of the intangible depends upon possession of the instrument.” Restatement of Security § 1 comment e (1941).
approach in the Fair Credit Billing Act,85 which prohibits a bank from setting off a debt arising from a consumer's use of a bank credit card, unless the cardholder has earlier authorized payment of such obligations out of the deposit account.86

In taking this intermediate approach, the assumption is that the use of secured transactions, facilitated by article 9, enhances the social welfare of all creditors and debtors. Some scholars disagree.87 They question whether article 9 in its present form is economically efficient and whether it unfairly redistributes wealth from unsophisticated creditors, who do not request security for a variety of reasons including ignorance and industry custom, to sophisticated creditors, who make use of the Code's generous provisions.88

Even these critics presumably would agree that substitution of an article 9 security interest for the doctrine of set-off would reduce the social costs of borrowing. So long as a depositary institution has the option to rely on set-off, it enjoys the

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86. The pertinent provision of the Fair Credit Billing Act states:

(a) A card issuer may not take any action to offset a cardholder’s indebtedness arising in connection with a consumer credit transaction under the relevant credit card plan against funds of the cardholder held on deposit with the card issuer unless—

(1) such action was previously authorized in writing by the cardholder in accordance with a credit plan whereby the cardholder agrees periodically to pay debts incurred in his open end credit account by permitting the card issuer periodically to deduct all or a portion of such debt from the cardholder's deposit account, and

(2) such action with respect to any outstanding disputed amount not be taken by the card issuer upon request of the cardholder.

(b) This section does not alter or affect the right under State law of a card issuer to attach or otherwise levy upon funds of a cardholder held on deposit with the card issuer if that remedy is constitutionally available to creditors generally.

Id. § 169, 88 Stat. at 1515 (codified at 15 U.S.C. 1666h (1982)).

Congress considered but rejected an outright prohibition against all set-offs because some banks offer a combination check credit and credit card plan at lower finance charges for consumers and lower discount rates for participating merchants. See S. Rep. No. 92-750, 92d Cong., 2d Sess. 7 (April 17, 1972).


88. Id.
economic advantages of being a secured creditor and more, without paying any of the costs.

Creditors who retain article 9 security interests can reduce the risks and costs of default. Like unsecured creditors, they cannot accurately estimate the likelihood of default, the number and size of competing claims against the debtor's assets should default occur, or what the debtor's worth will be. By taking a security interest, however, they can predict with some precision the priority of their claims in the encumbered portion of the debtor's pool of assets. The debtor may, of course, dissipate that collateral in advance of default. But it is less expensive for secured parties to monitor the encumbered property during the loan repayment period than it is for unsecured creditors to keep track of all the debtor's property. Finally, should default occur, collection costs for secured creditors are reduced. Without going to court, they can foreclose on the collateral and retain or sell it to satisfy the obligation outstanding. The creditor with a common law right to set-off also enjoys these benefits.

There are, however, some costs in obtaining an article 9 security interest. In a perfect market, the risk-averse creditor must bargain with the debtor to obtain the security interest and must pay for it in the form of a lower interest charge, a larger advance, or some other term of value to the debtor. In addition, the secured creditor bears the expense of giving public notice, enabling subsequent creditors to assess the debtor's debt/collateral ratio and to increase their charges for lending if appropriate and permissible under state law.

But the depositary institution with a right to set-off pays virtually none of these costs. If the depositor borrows from the bank where it keeps its deposit accounts, the right to set-off arises automatically without bargaining. Other creditors are unlikely to compete to lend on the security of deposit account collateral because common law priority rules, both in and out of bankruptcy, favor only the creditor who can obtain the right to set-off—the depositary institution. The depositary bank does not give public notice of its inchoate interest in the de-

89. Id. at 7-8.
90. Id. at 9-10.
91. Id. at 28 n.50.
92. Id. at 7.
93. Article 9 reduces such costs. Id. at 5.
94. See infra text accompanying notes 108-70.
95. See infra text accompanying notes 108-278, 279-373, 374-440.
DEPOSIT ACCOUNT FINANCING

posit account. Subsequent creditors, accordingly, may charge the debtor an artificially high interest rate to cover the possibility that the debtor may at some time borrow funds from the depositary bank.96

If this Article's recommendation were enacted, depositary institutions would continue to enjoy the rights and remedies afforded other secured creditors under article 9 but would have to pay for those advantages.97 To accomplish this result, the doctrine of set-off, now a historical anachronism, would be abolished, even as an alternative to the "new" article 9 security interest in deposit accounts as original collateral.

2. The Analogy to the Code's Treatment of Service Lienors

Examination of the policies that led Code sponsors to recognize the continued validity of the common law and statutory service lien structure helps illuminate why a similar continuing role for the common law doctrine of set-off would be inappropriate. A mechanic who repairs an automobile "on credit" can, by agreement with the customer, create an article 9 security interest and simultaneously hold a statutory lien for the repair bill under non-Code law. The mechanic who fails to obtain an effective security agreement can still assert rights as a statutory lienor.98 An official comment explains that the drafters of the Code thought it "unnecessary" to try to codify service liens because the present law is "in considerable part determined by local conditions."99 The comment also notes that these transac-

96. See infra text accompanying notes 237-78.
97. The preceding analysis assumes that the depositor-borrower will act rationally to maximize its economic welfare. Inertia, "sentimental" attachment to the depositary bank, or other noneconomic factors may lead to continued borrowing from the depositary institution at a higher than necessary rate.

Were article 9 available to creditors, reducing the transaction costs involved under the more uncertain and inadequate common law of assignments, an overall increase in the use of deposit account collateral in consensual credit transactions could result. See generally infra text accompanying notes 108-278. Critics of article 9 might be disturbed by such a consequence even if they would approve of abolishing the right to set-off.

98. See generally B. CLARK, supra note 44, ¶ 1.8[2], [3]. In some cases, article 9 defers to the priority rules established by this non-Code law. See, e.g., U.C.C. § 9-310.
99. U.C.C. § 9-104(c) comment 3. With increased urbanization, one can question whether the drafters actually believed that regional variations necessitated different combinations of liens. See 2 G. GILMORE, supra note 19, § 33.1, at 872-73. Perhaps they were only seeking to avoid confrontation with political representatives of industries and with tradespersons favored by the service lien structure out of a concern that enactment of article 9 might otherwise be jeopardized. See 1 G. GILMORE, supra note 15, § 10.4, at 306; 2 G. GILMORE, supra note 19, § 33.2, at 874. Similar considerations led to the omission of po-
tions are "far removed from ordinary commercial financing."

The tradespersons and other beneficiaries of the nonconsensual, non-Code protections clearly are not professional lenders directly involved in commercial credit transactions. The mechanic is in the business of repairing automobiles; the investment of labor and parts in advance of full payment, although arguably an extension of credit, is peripheral to the central undertaking. Neither the mechanic nor the automobile owner views the relationship as a credit transaction and they are unlikely to bargain concerning collateral. Under such circumstances it is appropriate to supplement consensual arrangements with statutory liens protecting mechanics against the risk of default, particularly because the state may want to ensure the continued viability of businesses such as automobile repair shops.

The continued "special protection" of the service lienor is also rationalized in terms of the limited harm such liens cause article 9 creditors. Although an earlier article 9 creditor may lose its priority to the mechanic, it purportedly benefits from the increase in the automobile's value attributable to the repair work. Nor are subsequent article 9 creditors greatly disadvantaged. Non-Code law usually requires the mechanic or other lien beneficiary to give public notice by either retaining possession of the collateral or filing in a designated public record.

In contrast, there would appear to be no justification for the continued existence of the right to set-off if article 9 were expanded to cover security interests in deposit accounts as original collateral. There are no "local conditions" that affect these major depositary institutions' rights to foreclose on deposit accounts. The primary business of these banks and thrift institutions is to extend credit to, and take billions of dollars of deposits from, consumers and businesses. In all other as-

100. U.C.C. § 9-104(c) comment 3.
101. See supra notes 6-10.
102. See supra note 19, § 33.3, at 878.
103. See id. comment. Note, in contrast, Professor Gilmore's skepticism over whether this "benefit" is often realized. See 2 G. GILMORE, supra note 19, § 33.3, at 878-81.
104. See 2 G. GILMORE, supra note 19, § 33.3, at 874.
pects of their business, they insist that they be allowed to con-
duct relationships with their depositors on a consensual
basis.106 Surely these professionals do not need a common law
set-off right to augment their carefully drafted agreements with
borrowers.

Moreover, preserving the right to set-off, unlike the service
lien, would present substantial problems for nondepositary
creditors who do not enjoy set-off's benefits. The volume of de-
positary institution lending makes frequent conflicts likely be-
tween creditors claiming a right to set-off and nondepositary
institutions that would have, at best, only the rights and reme-
dies of secured creditors under article 9. Also, depositary insti-
tutions, unlike service lienors, do not enhance the value of
collateral. Finally, different priority rules govern disputes
among creditors when the common law right to set-off is as-
serted.107 Depositary institutions would thus obtain an unfair
advantage over other creditors if they could "pick and choose"
among priority rules, both in and out of bankruptcy, in order to
maximize their recovery from the debtor.

In sum, depositors should be able to grant article 9 security
interests in their deposit accounts to creditors of their choice.
Such consensual financing arrangements, now governed by the
common law of assignments and pledge, can be brought within
the article 9 structure without distorting its theoretical under-
pinnings. For this reform to be effective, however, the common
law right to set-off must also be displaced. It has outlived its
historic equitable purpose. In its modern application, it gives
depositary institutions a powerful extrajudicial remedy against
valuable assets which is not granted by the express consent of
the debtor. Unlike holders of other statutory or common law
liens, such as service liens, the creditors who enjoy this doc-
trine's benefits are professional lenders needing no such "spe-
cial" protection.

106. U.C.C. § 4-103(1) provides in pertinent part:
The effect of the provisions of this Article may be varied by agreement
except that no agreement can disclaim a bank's responsibility for its
own lack of good faith or failure to exercise ordinary care . . . ; but the
parties may by agreement determine the standards by which such re-
sponsibility is to be measured if such standards are not manifestly
unreasonable.
Banks customarily incorporate their laws and bylaws into deposit agreements
with their customers.
107. See infra text accompanying notes 279-373.
II. RECOMMENDATIONS CONCERNING THE REQUIREMENTS FOR CREATING AN ARTICLE 9 SECURITY INTEREST IN DEPOSIT ACCOUNTS; THE DIMENSIONS OF SUCH SECURITY INTERESTS; AND THE METHOD OF PERFECTING SUCH INTERESTS

This section develops specific recommendations for making deposit account collateral subject to the provisions of article 9. In order to effectuate the article 9 goal of creating a unitary and comprehensive security interest, article 9 rules for other types of collateral are followed except where changes are necessary because of the unique characteristics of deposit account collateral. Comparisons are drawn to rules governing banks' common law right to set-off, as well as to the common law of assignments and pledge, which presently govern consensual liens against deposit accounts.

A. THE CREATION OF A SECURITY INTEREST IN DEPOSIT ACCOUNTS AS ORIGINAL COLLATERAL

Section 9-203(1) sets forth three general prerequisites for creating an enforceable article 9 security interest, each of which could be applied appropriately to deposit accounts as original collateral. If these requirements are satisfied, the security interest "attaches" and is enforceable against both the debtor and third parties. See U.C.C. § 9-203(1).

108. U.C.C. § 9-203(1) provides in pertinent part:

[A] security interest is not enforceable . . . and does not attach unless:
(a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral . . . .

110. A consumer-debtor may not understand that signing a detailed, standard-form article 9 security agreement, or a combined security agreement and promissory note, grants a security interest or that such a manifestation of "consent" authorizes the creditor upon default to appropriate the collateral. These problems arise under article 9 with respect to all forms of collateral and would be a matter of concern if article 9 were expanded to cover deposit account collateral. See generally Credit Practices Rule: Statement of Basis and Purpose and Regulatory Analysis, 49 Fed. Reg. 7740 (1984); Fed. Trade Comm'n, Report of the Presiding Officer on Proposed Trade Regulation Rule: Credit Practices 134-39 (Aug. 11, 1978).

Different solutions to this problem have been proposed at both the state and federal level that could easily be extended to protect depositors who hypothecate deposit accounts under an expanded article 9. For example, Kansas requires that the security agreement warn the consumer not to sign the agreement before reading its terms; the security agreement also must disclose that the consumer may prepay the unpaid balance without incurring a penalty. See KAN. STAT. ANN. §§ 16a-3-202 (1981). The Truth in Lending Act, P.L. 90-321, 82
eliminates the need to resort to parol evidence in the event of a dispute concerning the parties' intentions. The depositor could enter into such a security agreement with, or deliver possession of the collateral to, either a depositary institution or an outside creditor. Moreover, if the depositor chose to use a security agreement, it could grant security interests in its deposit account as original collateral to more than one creditor, either simultaneously or sequentially.

Article 9 requires that the written security agreement include a general description of the collateral sufficient to "reasonably" identify "what is described." A somewhat more stringent description requirement should be enacted for deposit account collateral. Additional information is necessary to


Depending on the nature of the consumer credit protection statute, the definition of what constitutes a "consumer deposit account" could vary. For example, a state could require inclusion of the "Kansas disclosures" in any security agreement covering a deposit account used "primarily for personal, family or household purposes." See U.C.C. § 9-109(1) (definition of "consumer goods").

On the other hand, in applying the FTC Credit Practices Rule's prohibition of non-purchase money security interests, the size, as well as the purpose, of the deposit account might be taken into consideration. See, e.g., U.C.C. § 1.301(15) (1974) (definition of "consumer loan"). Thus, for example, the rule might proscribe retention of a non-purchase money security interest in a deposit account used primarily for household purposes, with a balance of less than $5,000 on the day credit was extended.

U.C.C. § 9-203(1)(a) thus operates as a statute of frauds for secured transactions. See 1 G. Gilmore, supra note 19, § 11.4, at 345-46; U.C.C. § 9-203 comment 5.

As explained below, see infra text accompanying notes 237-78, a subsequent potential creditor could discover the earlier creditor's interest in the deposit account by searching public records. With that information, the subsequent potential creditor could either abandon the deal, enter into an agreement with the debtor (secured by the deposit account) on terms that reflect the higher risk, or attempt to obtain a subordination agreement from the earlier creditor. See U.C.C. § 9-316.

U.C.C. § 9-203(1)(a).

Id. § 9-110 ("any description of personal property . . . is sufficient whether or not it is specific if it reasonably identifies what is described").
enable the depositor and its creditors to allocate the value represented by the balance in the account in a manner that will neither invite subsequent disagreements between the parties nor mislead third parties. Specifically, article 9 should require that the security agreement's "description" of deposit account collateral include, at a minimum, the name of the depositary institution, that institution's identifying number for the account hypothecated, and the sum within the account allocated to secure the particular loan.

Compliance with these formal requirements would not be overly burdensome for creditors. Depositary and nondepositary creditors presently take article 9 security interests in tangible, quasi-tangible, and intangible property. These creditors have standard form security agreements and guidelines for the negotiation of individualized security agreements. Most of these forms and guidelines, with minor modifications, could be used for security interests in deposit accounts as original collateral. Advances or lines of credit will often be secured by more than one form of collateral. Only one security agreement need be executed. The description of the deposit account collateral could simply be added where the more traditional collateral is now listed. Given the sophistication and accuracy of bank record keeping, neither a depositary creditor nor an outside creditor (through the debtor) would have difficulty obtaining and accurately recording the necessary information.

115. Consider, for example, the debtor who decides to hypothecate $2,000 of the value of a $10,000 deposit account to the depositary institution to secure a $3,000 advance and another $5,000 of the value of the same deposit account to an outside creditor who provides a line of credit on more favorable terms. Each creditor needs to discover the existence and size of the other's interest in the account. Moreover, this information is necessary to permit application of common law tracing rules to commingled funds.

116. It is proposed that these additional requirements be added as a second sentence to the present U.C.C. § 9-110. That section's guidelines apply both to security agreements and financing statements. See U.C.C. § 9-402(1); I G. Gilmore, supra note 19, § 11.4, at 348-49 n.7. This Article recommends, see infra text accompanying notes 237-78, that filing of a financing statement be required to perfect a security interest in deposit accounts as original collateral; ready access to this minimal identifying information would be helpful to third parties using the public notice files.

117. Tangible property covered by article 9 includes "all things which are movable . . . or which are fixtures." See U.C.C. § 9-105(h).

118. Quasi-tangible personal property covered by article 9 includes "documents," "instruments," and "chattel paper." See id. § 9-105(b), (f), (i).

119. Intangible property includes "accounts" and "general intangibles." See id. § 9-106.

120. One of the significant improvements of article 9 over pre-Code security law is that only one set of formalities to create an encumbrance must be satisfied for most types of personal property.
identifying information.\textsuperscript{121}

A second prerequisite to creation of an article 9 security interest is that the debtor have "rights in the collateral."\textsuperscript{122} Article 9 defers to other articles in the Code and to non-Code law for resolution of issues concerning the debtor's ownership or other authority to hypothecate collateral.\textsuperscript{123} A similar approach could be followed in ascertaining whether the debtor had the right to encumber a deposit account and, if so, to what extent. Thus, non-Code law would govern questions such as whether one of two signatories on a joint checking account could grant an article 9 security interest without the other's consent; whether a partner could encumber a partnership's nonnegotiable savings certificate in order to obtain a personal loan; or whether a trustee would exceed its authority by signing a security agreement covering the trust's deposit account.\textsuperscript{124}

Article 9's final prerequisite is that the secured party give "value," ordinarily in the form of money advanced or delivery of goods on credit.\textsuperscript{125} As with other more traditional collateral, there is no need in a commercial statute to regulate gifts of interests in deposit accounts.\textsuperscript{126}

\textsuperscript{121} The text of U.C.C. § 9-110 and the accompanying official comment make it clear that article 9 rejects the "serial number" test which was employed in pre-Code chattel mortgage cases and statutes. See B. Clark, \textit{supra} note 44, ¶ 2.9[5] [c]; 1 G. Gilmore, \textit{supra} note 19, § 11.4. The proposal here for more detailed descriptions of "deposit account" collateral may be reminiscent of the earlier standard. Depositary institutions, however, unlike the vast array of manufacturers, retailers, and others covered by chattel mortgage statutes, have independent business needs to identify individual accounts by number and to keep accurate daily records of the transactions in such accounts. Moreover, the liquidity, divisibility, and fungibility of this type of collateral necessitates a more detailed description of the parties' intent concerning the scope of the encumbrance. Minor errors in description, however, need not be fatal. For example, if one digit of the deposit account number reported on the security agreement or financing statement was in error but no one was seriously misled the description would be sufficient. See U.C.C. § 9-402(8).


\textsuperscript{122} U.C.C. § 9-203(1)(c).

\textsuperscript{123} See B. Clark, \textit{supra} note 44, ¶ 2.4.

\textsuperscript{124} These and similar questions arise in cases where a bank wants to set-off against joint accounts, partnership accounts, and trust accounts. See infra note 166 and sources cited therein.

\textsuperscript{125} See U.C.C. § 9-203(1)(b). U.C.C. § 1-201(44), incorporated into article 9, contains a broad definition of "value," including executory promises and "any consideration sufficient to support a simple contract." Compare this broad definition with U.C.C. § 3-303 (a narrower definition of "value" for determining "holder in due course" status).

\textsuperscript{126} Such gifts would continue to be governed by the common law of assignments. See, e.g., \textit{Restatement (Second) of Contracts} § 332 (1979) (revocability of gratuitous assignments).
Once all three of the foregoing requirements are satisfied, in any order, the creditor holds an enforceable, attached security interest.\textsuperscript{127} If these article 9 requirements were to displace the common law requisites for effective transfer of an interest in a deposit account, there would be little disruption of current commercial practices and the law would become more certain and more accessible. Under the present Code, the requirements for creating a security interest in a negotiable certificate of deposit are the same as for other collateral; under this proposal, the same requirements would apply to security interests in all deposit accounts.\textsuperscript{128}

There is considerable confusion and nonuniformity under the common law of security assignments and pledge, as modified by state statutes, concerning how interests in deposit accounts can be conveyed so that, at a minimum, the transfer would be effective between the lender and the borrower.\textsuperscript{129} Part of the confusion stems from the functional similarity but metaphysical difference between a common law pledge and a security assignment.\textsuperscript{130}

127. See U.C.C. § 9-203.

128. See id. §§ 3-104(1), (2)(c), 9-102, -104(b), -105(1)(e), -105(1)(i); see also, e.g., Southview Corp. v. Kleberg First Nat'l Bank, 512 S.W.2d 817 (Tex. Civ. App. 1974). One commentator has urged that a nonnegotiable certificate of deposit be treated as a certificate of deposit within the meaning of article 9, thereby permitting retention of an article 9 security interest in such collateral. See Harris, supra note 25. A number of courts have reached this result without adequate analysis of the statutory basis for their conclusion. Id. at 331 nn.6-7.

Under this Article's proposal, nonnegotiable certificates of deposit, as well as checking accounts, NOW accounts, savings accounts, money market deposit accounts, and other similar arrangements, would all be categorized as "deposit accounts" but would nonetheless fall within article 9's scope. California follows such an approach, excluding only the negotiable certificate of deposit from the definition of "deposit accounts." See CAL. COM. CODE § 9105(1)(e) (West Supp. 1984).

California and Hawaii, the only states permitting retention of an article 9 security interest in all deposit account collateral, did not change the requirements for creating such interests. See CAL. COM. CODE §§ 9104, 9203 (West 1964); HAWAI REV. STAT. §§ 490:9-104, -203 (1976). But, as discussed elsewhere in this Article, these states have not enacted the Article's other suggested modifications to article 9 nor have they abolished the common law right to set-off.

129. With exceptions, see infra text accompanying notes 279-373, the lender who either creates a common law pledge or a security assignment ordinarily accomplishes, by the same acts, what is necessary to protect its rights (to the degree possible) against competing claimants. The lender who is a pledgee gives general public "notice" of its encumbrance to potential creditors and purchasers, who might otherwise rely on the same deposit account collateral, by retaining possession of the property during the loan repayment period. Anomalously, the giving of such notice is not important in most jurisdictions with regard to the rights of the common law assignee against successive assignees. See infra text accompanying notes 248-49.

130. As explained in the Restatement of Security:
The pledge, a special kind of lien, is created by a bailment of the collateral (here a chose in action) to the secured party. Title to the collateral remains in the depositor during the loan repayment period; the secured party receives mere possession. When the loan is repaid, the bailed collateral is returned. If the loan is not repaid, the pledgee has an express or implied right to foreclose on the property to satisfy the outstanding debt.

In a security assignment of a chose in action, title to the property is transferred to the lender. A present but conditional transfer is made; the assignee receives title to the depositor-assignor's contract claim against the depositary institution, but that right of payment is subject to the condition that the assignor default on the loan. If the loan is repaid, the claim assigned reverts to the depositor; if the depositor defaults, the assignee's right becomes enforceable and it can demand payment from the depositary bank to satisfy the outstanding balance.

Thus a pledge requires immediate delivery of possession, whereas a security assignment requires immediate delivery of

The early common law recognized pledge interests only in tangible chattels. Modern law allows pledge interests also ... in intangibles. With the development of the rules as to the assignability of choses in action ... and the consequent availability of choses in action to secure the performance of duties, the distinction between pledges and other security devices has often been obscured. ... [T]he protection[s] accorded the creditor with a security interest in personality [are] much the same whatever the name given the security device. ... Security assignments of contracts are often called pledges, although they constitute title, rather than possessory, security.


133. See Moss Indus., Inc. v. Irving Metal Co., 142 N.J. Eq. 704, 61 A.2d 159, 162 (1948); Restatement of Security § 48 (1941).
134. The Restatement (Second) of Contracts defines an assignment as "a manifestation of the assignor's intention to transfer [title] ... by virtue of which the assignor's right to performance by the obligor is extinguished in whole or in part and the assignee acquires a right to such performance." Restatement (Second) of Contracts § 317(1) (1979). The Restatement validates the conditional assignment and explains that such a transfer "does not wholly extinguish the assignor's right until the condition occurs." Id. § 331 comment b; see Miller v. Wells Fargo Bank, 406 F. Supp. at 472-73; A. Corbin, Corbin on Contracts §§ 875, 881 (1951).
135. See A. Corbin, supra note 134, §§ 875, 881.
title, even if conditioned on a future event. But both security devices have identical practical consequences for the relationship between the depositor-debtor and creditor at the time of default or repayment. In the case of default, the lender has or obtains title and possession; in the case of repayment, the depositor regains title and possession. Perhaps for this reason, article 9 rules concerning how and when a security interest becomes enforceable between the debtor and lender disregard the location of title.

The common law formalities for creating each of these security devices overlap, making it difficult in some cases to ascertain which device the parties intended to create. A pledge may be created by delivery of the collateral with an accompanying writing setting forth the terms of the bailment; a security assignment may be made by an identical delivery and an agreement setting forth the terms of the assignment.

In addition, there is uncertainty about what the formal requisites for the two devices are. If the parties want to create a pledge the collateral must be delivered. But delivery of an intangible, such as a depositor's chose in action, can only be accomplished if the intangible is represented by a "symbolic writing" or "indispensable instrument." In the deposit account context, the use of electronic funds transfers, combined with the proliferation of new types of accounts, makes it increasingly difficult to ascertain whether there is such a writing and, accordingly, whether any particular deposit account can be pledged. It is clear that a negotiable certificate of deposit or a savings account accessible solely by means of a passbook can be pledged by delivery of the certificate or the passbook to the lender. On the other hand, delivery to the lender of a book of blank checks for a standard checking account would


137. Article 9 broadly provides: "[E]ach provision of this Article with regard to rights, obligations and remedies applies whether title to collateral is in the secured party or in the debtor." U.C.C. § 9-202; see also id. §§ 1-201(37), 9-203 comment 4.

138. See supra note 130. See generally 1 G. Gilmore, supra note 19, §§ 1.1, 2.

139. See Miller v. Wells Fargo Bank, 406 F. Supp. at 469-72, 477-79; 1 G. Gilmore, supra note 19, § 1.3; Restatement of Security § 1 comment e (1941).


not create a pledge.142 But what about an automatic teller card that accesses both demand and savings accounts? Is the monthly statement for a Money Market Deposit Account, allowing only three transfers by check per month, the equivalent of a passbook? What about a telex key and code used by a depositor to give instructions to a bank in international transactions?143

It is not even clear what the focus of this inquiry should be. The Restatement of Security emphasizes the indispensability of the writing, explaining “[i]f the instrument cannot be produced, the interest which it represents can be effectively asserted only by accounting for the absence of the instrument and obtaining as a substitute for it, either a duplicate or some form of court decree.”144 Gilmore suggests that any instrument for the payment of money that professionals use in institutional commercial transactions should suffice, as well as any instrument executed with formality that suggests on its face “that the parties looked on it as a serious undertaking.”145 A federal district court recently adopted a more pragmatic view, examining whether possession of the particular writing was likely to result in subsequent creditors learning of the earlier encumbrance.146

If a security assignment, rather than a pledge, is intended, lenders must satisfy Statute of Frauds requirements. Although an oral assignment is valid under the common law,147 an oral sale of a contract right is not enforceable under the Code “by way of action . . . beyond five thousand dollars in amount or value of remedy.”148 In addition, some state statutes specifi-

142. Without more, the delivery of a check does not operate as an assignment of a deposit account. See U.C.C. § 3-409. See generally B. Clark, The Law of Bank Deposits, Collections and Credit Cards ¶ 3.1[2][a] (1981).
143. See Miller v. Wells Fargo Bank, 406 F. Supp. at 470 n.13 (telex key and code insufficient where purported pledgee had not established that it would not take instructions from the debtor by mail or other media).
144. Restatement of Security § 1 comment 3 (1941).
146. See Miller v. Wells Fargo Bank, 406 F. Supp. at 469.
147. See, e.g., Moran Bros., Inc. v. Yinger, 323 F.2d 699, 701 (10th Cir. 1963) (oral agreement sufficient); Marx v. Maddrey, 106 F. Supp. 535, 541 (E.D.N.C. 1952) (oral agreement effective between depositor and assignee but not against third parties); Willow City Farmer's Elevator v. Vogel, 288 N.W.2d 762, 764-65 (N.D. 1978) (oral assignment of checking account is valid as security); cf. Walton v. Piqua State Bank, 204 Kan. at 755-57, 465 P.2d at 329 (a written assignment or delivery of a savings account passbook will suffice but an oral agreement is not effective between the parties). See generally A. Corbin, supra note 129, at § 879; Restatement (Second) of Contracts § 324 (1979).
cally provide that a security assignment of a savings account requires delivery of the passbook with a written order for transfer, irrespective of the amount in the account.\textsuperscript{149}

Antiassignment clauses in agreements between depository banks and their customers introduce another element of uncertainty. Such clauses are unenforceable if the transaction is within the scope of article 9.\textsuperscript{150} But under non-Code law governing the conveyance of title in deposit accounts, express antiassignment clauses, although narrowly construed, may be enforced by specific performance.\textsuperscript{151}

Yet another troubling issue under the common law of security assignments is whether a purported assignment sufficiently divests the assignor of control and interest in the right transferred.\textsuperscript{152} A court may conclude that the language of the "assignment" merely reflects a promise to pay the purported assignee out of a designated fund or an instruction to the depository bank to make such payment.\textsuperscript{153}

Not surprisingly, prudent lenders, faced with these uncertain legal requirements, and possibly for business reasons as well, often insist on both a written security assignment and a pledge effected by delivery of a "symbolic writing" representing the deposit account.\textsuperscript{154} Under article 9, these lenders could protect their legal interests fully without requiring the depositor to forego all use of the deposit accounts during the loan repayment period. A written security agreement when combined with a public filing pursuant to article 9 would give the lender a fully enforceable interest against the debtor and protection from competing subsequent creditors, whether or not the debtor delivers any "symbolic writing" or "indispensable in-

\textsuperscript{150} See U.C.C. § 9-318(4). But see J. Murray, Murray on Contracts § 306 (2d ed. 1974).
\textsuperscript{151} See, e.g., Rosenstein v. Mechanics & Farmers Bank, 304 N.C. 541, 544-45, 284 S.E.2d 504, 506-07 (1981) (prohibition in savings passbook of assignment of passbook does not restrict assignment of underlying chose in action); see also A. Corbin, supra note 134, §§ 872-873; J. Murray, supra note 150, § 306; Restatement (Second) of Contracts, § 322 (1979).
\textsuperscript{153} See, e.g., Miller v. Wells Fargo Bank, 406 F. Supp. at 473.
strument." Thus, the parties would have the freedom to agree that the depositor should be left in possession of the deposit account, thereby fostering greater efficiency in the depositor's financial affairs and increasing the likelihood of improvement in its financial position and repayment of the loan.

As presently drafted, section 9-203(1)(a) gives parties the option of creating a security interest by delivery of the collateral pursuant to agreement. In the deposit account context, this alternative presents interpretive difficulties similar to those under the common law of pledge; one must determine what deposit accounts are to be reified. Serious consideration should be given to eliminating this method of creating a security interest, thereby promoting uniform treatment of all deposit accounts. Alternatively, the text and official comments to the Code should provide guidance about what constitutes an indispensable or symbolic writing.

A comparison of the Code's requisites for creating a security interest in a deposit account with common law requirements for establishing a depositary institution's inchoate right to set-off also reveals how the law governing deposit account

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156. This Article proposes that a creditor who wants to protect its interest in deposit account collateral created under § 9-203(1) against competing subsequent creditors, as well as against the depositor, must give "public notice" of the interest. See U.C.C. §§ 9-203(1), -303(1). Although the sometimes ambiguous procedure of taking possession of the symbolic writing representing a deposit account will suffice to create a security interest good against the depositor, this Article recommends that if the secured creditor seeks priority over competing claimants, it must file a financing statement in the public records. See id. § 9-302(1). Otherwise third parties, not involved in the initial choice, could be harmed by subsequent disputes about whether an "indispensable instrument" had been delivered.

157. See supra notes 139-43 and accompanying text.

158. The term "inchoate right to set-off" is used to describe the occurrence of all the preconditions for the exercise of the set-off remedy. Under article 9, a creditor with a security interest may occupy one of three statuses: it may be secured but unperfected, or it may be secured and perfected, or it may be secured and have effected foreclosure on its interest. See, e.g., U.C.C. §§ 9-502, 9-503. In contrast, there are only two possible statuses under the common law of set-off. Once "mutual indebtedness" arises, the bank has an inchoate right to set-off. The exercise of that right is the equivalent of foreclosure on an article 9 security interest. The bank's right to set-off is unaffected by whether it gives notice to other creditors; thus there is no status equivalent to that of a secured party with a perfected security interest. It is the absence of this status in the common law scheme that makes it difficult to resolve priority battles between the bank with a right to set-off and an article 9 secured creditor, the Internal Revenue Service with a tax lien, or the trustee in bankruptcy with its powers of
financing would become more flexible, certain, and equitable by expanding the scope of article 9. It is useful to begin with the requirements that are similar.

Courts uniformly hold that the inchoate common law right to set-off against a deposit account arises only where there is "mutual indebtedness" between the depositor and the credit institution. One aspect of this requirement is that a mature obligation must run from the depositor as "obligor" to the credit institution as "obligee." Ordinarily, this obligation is the depositor's promise to repay a loan with interest. Should the depositor default, one-half of the mutual indebtedness requirement is satisfied. Courts recognize the power of the parties to define by agreement what constitutes a "default." Thus, the mutual indebtedness requirement parallels the article 9 requirements that the credit institution give "value" and that the debtor be in default before foreclosure.

The other half of the mutual indebtedness requirement is that an obligation must run from the credit institution, now the "obligor" on the deposit agreement, to the depositor, now the "obligee." To ascertain the "true obligee" in any particular case, a court must confront the same issues that arise under article 9's requirement that the debtor have "rights in the collateral."

But there the similarities end. The mutual indebtedness avoidance under the Bankruptcy Reform Act. See infra text accompanying notes 279-373, 374-440.

160. See B. CLARK, supra note 142, ¶ 11.6.
161. Id.
163. See supra note 125 and accompanying text.
164. U.C.C. § 9-501(1) provides in pertinent part: "When a debtor is in default under a security agreement, a secured party has the rights and remedies provided in this Part . . . ." (Emphasis added).
165. See sources cited supra note 159.
166. See U.C.C. § 9-203(1)(c); see also supra notes 122-24 and accompanying text. On the question of whether the bank can set-off against one of two signatories on a joint account, see B. CLARK, supra note 142, ¶ 11.6[4]; Hagedorn, supra note 159, at 1002-04; TeSelle, supra note 70, at 45-46; Annot., 68 A.L.R.3d 192 (1976); against a partnership account, see TeSelle, supra note 70, at 46; against a special purpose account, see id. at 46-48; Hagedorn, supra note 159, at 993-96; against the deposit account of a deceased debtor, see Murray, supra note 71, at 457-58; TeSelle, supra note 70, at 50; and against a trust account, see Hagedorn, supra note 159, at 1004.
requirement of set-off can only be satisfied when the credit institution that loans money to the depositor is also the depositary institution. Thus the common law right to set-off, unlike the article 9 security interest (or the common law pledge or assignment), is limited to one class of favored credit institutions.

Even more significantly, the right to set-off, unlike an article 9 security interest, arises by operation of law.167 There is no requirement that the depositor manifest consent, in writing or otherwise.168 Simply by accepting credit, the depositor is deemed to have granted the depositary institution, and that institution alone, a right to the full value of all its general deposit accounts in that institution in the event of default. Moreover, priority rules both in and out of bankruptcy favor the bank, with its right to set-off, over other creditors with competing claims169 and thereby discourage outsiders from competing to lend against this collateral. Of course, borrowers can avoid the banks' right to set-off by creating special, segregated deposit accounts or by not entering into credit arrangements with institutions where they maintain deposit accounts. But many borrowers are not aware of their exposure to the bank's right to set-off. Even for sophisticated borrowers, the cost of avoiding creation of the right to set-off could be substantial—the loss of the added convenience and other advantages of "one-stop financial services," widely advertised by the banks themselves.170

167. See generally sources cited supra note 159.

168. See generally B. CLARK, supra note 142, ¶ 11.1 (1981). In a few states, statutes expressly require debtor consent; but mere reference to set-off in the terms and agreement of the bank, incorporated by reference in the signature card, will suffice. Biby v. Union Nat'l Bank, 162 N.W.2d 370, 374-76 (N.D. 1968); see supra note 86.

169. See infra text accompanying notes 279-373, 374-440.


Banks often advertise packages of services. For example, in September 1983, the National Bank of Washington offered customers with both a checking account and $2,500 in a regular savings account, or $10,000 in either a Money Market Account or a certificate of deposit, a package of ten services, including "no-service charge checking, distinctive checks at no charge, leather checkbook cover at no charge, preferred CHEXTRA rate (at least 2% less than prevailing rate), specially designed NBW National Bankcard, special consumer loan telephone line, traveler's checks at no charge, quarterly newsletter, financial planning seminars, American Express Gold Card . . . ."

As explained by Secretary of the Treasury Regan:

The sophisticated consumer today would like to include in his savings and investments such things as a NOW account for liquidity purposes, a money market deposit account to earn a higher rate of interest on slightly less liquid funds and securities or even an insurance or annuity contract for long term savings and investment. He would like to
Substituting an article 9 security interest in deposit accounts as original collateral for the common law of assignments, pledge, and set-off would thus allow depositors to decide for themselves under what circumstances, and in favor of whom, to hypothecate these valuable assets.

B. THE SCOPE OF THE ARTICLE 9 SECURITY INTEREST IN DEPOSIT ACCOUNTS AS ORIGINAL COLLATERAL

An article 9 secured party may, by agreement with the debtor, retain a “floating lien”: a security interest of substantial and elastic dimensions. If the security agreement includes an “after-acquired property” clause, the collateral securing the obligation expands automatically to encompass designated types of property later acquired by the debtor. If the parties agree to a “future advances” clause, additional funds subsequently advanced by the creditor are automatically secured by the collateral described in the original security agreement; no second security agreement need be executed. If the debtor disposes of encumbered original collateral, the creditor is presumed to have a security interest in the “proceeds” received by the debtor. If such a sale of collateral breaches the security agreement, the secured party’s interest in the original collateral may continue even when the property is in the hands of third

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Regan Testimony, supra note 8, at 7, NEW BANKS AND NEW BANKERS at 390.

Recent consumer surveys show that individuals select the depositary institutions where they maintain a checking account primarily on the basis of locational convenience and the availability of a wide variety of services. The majority of individuals maintain two or more accounts at the place where they keep their checking account. See Survey, Customer Service Usage—Part II, The Unidex Report, June 1982, at 1-2 (publication of the Unidex Corporation).

171. An example of an “after-acquired property” clause would be a clause in the agreement covering “all equipment now owned or hereafter acquired by the debtor.”

172. No new security agreement need be executed. See generally B. CLARK, supra note 44, ¶ 10.1[1].

173. A typical “future advances” clause might provide that “the above described collateral secures the payment of $10,000 plus interest and the payment of all other indebtedness at any time hereafter owing by Debtor to Secured Party.”

174. See U.C.C. § 9-204(3). See generally B. CLARK, supra note 44, ¶ 10.1[3]. Courts may refuse to construe a broad, “dragnet” future advances clause as covering a second advance if the second loan’s purpose is dissimilar to that of the first advance, if its form is different, or if too great a time period has elapsed between the two advances. Id.

175. See U.C.C. §§ 9-203(3), 9-206(2).
DEPOSIT ACCOUNT FINANCING

parties. Should article 9 be expanded to cover deposit account collateral, its provisions, with minor modifications including the addition of common law tracing rules, would provide a framework in which depositary and nondepositary credit institutions could bargain for similar floating liens over nonconsumer deposit accounts.

If depositors and creditors are to be free to bargain regarding the use of deposit accounts as collateral, a rule for separating different entities' interests in commingled funds must be adopted. One such rule is the lowest intermediate balance rule, which courts presently apply to measure an article 9 proceeds security interest in a commingled deposit account.

Under the lowest intermediate balance rule, any withdrawal from the deposit account would come first out of funds not encumbered by the article 9 security interest. If the balance were to fall below the amount specified in the security agreement, the secured creditor's interest would be limited to that "lowest intermediate balance." If a subsequent deposit were made, it would not be subject to the earlier security interest without the depositor's express consent. In other words, such a later deposit would not be deemed to be in restitution for the difference between the sum specified in the security agreement and the lowest intermediate balance.

The following series of examples illustrates how this rule, in conjunction with article 9's provisions, would define the dimensions of an individual creditor's security interest in a deposit account as original collateral. Where appropriate, the result under article 9 is contrasted with the result under the law of set-off and the principles governing pledges and security assignments. A later section of the Article examines priority battles among several creditors with interests in the same deposit account.

176. See id. § 9-306(2).


178. In other words, the withdrawal would first be credited against the nonencumbered portion of the depositor's chose in action against the bank.


180. See infra text accompanying notes 279-373.
1. Changes in the Account Where There is No “After-Acquired Deposit” Clause

   Example 1:
   The depositor has a $10,000 deposit account. No third party has an interest in the account. The depositor grants the bank a security interest in $3,000 of the account to secure a $2,000 loan. The depositor draws down the account to $1,000. No repayment is made on the bank loan.

   In this example, should the depositor default, the bank with an article 9 security interest could foreclose on the remaining $1,000 of value in the account. Under the lowest intermediate balance rule, it is presumed that $7,000 of the $9,000 withdrawn belonged to others. Under the common law, the bank, by virtue of a properly executed assignment or the exercise of its right to set-off, could “collect” the $1,000 in the deposit account at the time of default. If the bank had insisted on the delivery of an indispensable writing creating a pledge, the depositor presumably could not have withdrawn the encumbered funds and the bank could have recovered the full $2,000 owed.

   Example 2:
   The depositor has a $10,000 deposit account. No third party has an interest in the account. The depositor grants an outside creditor a security interest in $3,000 of the account to secure a $2,000 loan. The following activity occurs:
   Day 1: The account has a balance of $10,000.
   Day 2: The depositor withdraws $9,000, leaving a balance of $1,000.
   Day 3: The depositor deposits $5,000 of wholly owned funds, leaving a balance of $6,000.

   Should the depositor default without repaying the $2,000 loan, the outside creditor with the article 9 security interest can foreclose on only $1,000 of the $6,000 balance. As in the prior example, on Day 2, under the lowest intermediate balance rule, the $1,000 remaining in the account is encumbered, but the other $2,000 of value subject to the outside creditor’s security interest has been disbursed. The subsequent deposit on Day 3 simply adds “unencumbered” funds.

   The same result would occur under the common law of assignments and pledge. At the time of the assignment, and prior to Day 3, the depositor did not have a chose in action against the depositary institution for the additional $5,000. The assignment did not by its terms purport to transfer such a “future right”,181 if it had, as explained in example 3 below, the assignment would not have been fully effective. Similarly, if the de-

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181. See E. Farnsworth, supra note 3, § 11.5, at 766.
Deposit account were reified and a writing representing $3,000 of
the original balance had been pledged to the outside creditor,
additional steps would have had to be taken to effectively grant
security in the after-acquired deposit.\footnote{182}

Under the common law of set-off, the outside creditor in ex-
ample 2 would have no self-help remedy against the account
because there would be no mutual indebtedness.\footnote{183} If the cred-
itor were the depositary institution, however, it could set-off
against $2,000 of the $6,000 balance. The common law right to
set-off, available only to the depositary institution, extends,
without agreement, to all the debtor's funds in the account at
the time of default.\footnote{184} As illustrated in example 3 below, if arti-
cle 9 were substituted for the common law, the depositary insti-
tution would come out as well only if it had bargained with the
depositor for an "after-acquired deposit" clause in the security
agreement. Without such a clause, the secured party would
have to go to court and sue for the $1,000 deficiency.\footnote{185}

These two examples show how the continued existence of
the set-off doctrine would undermine article 9's policies: a de-
positary institution would have no incentive to bargain with a
depositor for an after-acquired deposit clause if it knew it could
reach the debtor's entire chose in action by asserting its more
powerful common law right to set-off. Moreover, even if an af-
ter-acquired deposit clause were included, under the common
law of assignments and pledge, it would create only an "equita-
ble" charge against the after-acquired deposit.\footnote{186}

2. Changes in the Account Where There is an "After-
Acquired Deposit" Clause

\textit{Example 3:}

Same facts as example 2, except that the security agreement includes
an "after-acquired deposit" clause.

Should the depositor default without repaying the $2,000
loan, the article 9 secured creditor now could foreclose on

\footnote{182. As noted earlier, if the pledge were created by delivery of an indispen-
sable writing, and if the writing was not subsequently released to the depositor,
the withdrawal on Day 2 would not have been possible. \textit{See supra} notes 139-46
and accompanying text. On the other hand, an unauthorized withdrawal might
take place if the pledge were created by delivery of a symbolic but not indis-
pensable writing. \textit{See Restatement of Security} §§ 1, 10 (1941).
\footnote{183. The outside creditor is not a party to the deposit agreement contract; it
is an "obligee" but not an "obligor." \textit{See supra} text accompanying note 159.
\footnote{185. \textit{See U.C.C. § 9-502(2).}
\footnote{186. \textit{See infra} notes 188-97 and accompanying text.}
$2,000 of the $6,000 balance. Applying the lowest intermediate balance rule, the secured party has an interest in $1,000 on Day 2. The subsequent deposit of $5,000, covered by the "after-acquired deposit" clause of the security agreement, increases the encumbered collateral to $6,000; thus, $2,000 of the account would be used to repay the loan and the balance would be remitted to the depositor.187 Through bargaining with the debtor, the secured party would have protected its interest to the same extent that the depositary institution's interest is protected by the doctrine of set-off.

Under present law, a nondepositary institution would have to base its claim to the subsequent deposit on either the common law of assignments or, if the deposit account was represented by a "symbolic writing," on the law of pledge. Even if the debtor explicitly agreed in writing to assign after-acquired deposits as security, courts often refuse to give full effect to such purported present transfers of future contract rights not yet "earned" by performance.188 The reluctance to enforce such assignments reflects both a historical antipathy to assignments of contract rights in general189 and a conceptual problem—the debtor is attempting to presently convey a contract right not yet owned or in existence.190

Exceptions to this common law prohibition have evolved to meet the needs of participants in a modern credit economy.191 For example, the Restatement (Second) of Contracts would give full effect to an assignment of a future right to payment "expected to arise out of an existing employment or other continuing business relationship."192 No cases were located, however, where the depositor's relationship to the bank was characterized as the necessary kind of "continuing business relationship."193 Although it is reasonable to predict that an employee-

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188. See E. Farnsworth, supra note 3, § 11.5; Restatement (Second) of Contracts § 321 (1979).
190. See Restatement (Second) of Contracts § 321 comment b (1979).
193. The comments and illustrations following § 321 of the Restatement do not apply its principles to a depositor's relationship with the depositary institution, although elsewhere the Restatement acknowledges that the law of assign-
assignor who continues to work at the same job will earn future rights to payment, there is little basis for assuming that a depositor will make sufficient future deposits, relative to subsequent withdrawals, to generate future rights to payment.

The depositor and creditor in example 3 could also rely on the common law doctrine of equitable assignments as an exception to the prohibition of assignments of future rights. The purported present transfer of the future deposit accounts would be viewed as a promise by the depositor to assign such rights when they arise. In example 3, if the depositor did not make a subsequent assignment on Day 3, the creditor could bring an action against the depositor for specific performance.

The equitable assignee, however, would be better off in several respects if it could rely on an article 9 floating lien. The law under article 9 is more consistent and coherent; the creditor need not ensure that the depositor executes subsequent assignments when it later acquires future contract rights. Instead, the article 9 security interest attaches automatically when a deposit is made and the depositor thereby obtains rights in the after-acquired collateral. The article 9 creditor thus is spared monitoring and transaction costs which, if the account were active, could prove quite substantial.

In addition, an article 9 creditor would prevail in circumstances where the equitable assignee's rights to future deposits could be subordinated to interests of competing creditors. If on the afternoon of Day 3, after the deposit of $5,000 and before the debtor executed a second assignment to the outside creditor, a judgment creditor of the depositor garnished the deposit account, the judgment creditor's execution lien would be senior to the outside creditor's equitable lien.

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196. See U.C.C. § 9-204(1); D. BAIRD & T. JACKSON, supra note 57, at 32. Official comment 1 to § 9-204 explains:

Subsection (1) makes clear that a security interest arising by virtue of an after-acquired property clause has equal status with a security interest in collateral in which the debtor has rights at the time value is given under the security agreement. That is to say: the security interest in after-acquired property is not merely an "equitable" interest; no further action by the secured party—such as the taking of a supplemental agreement covering the new collateral—is required.

197. Mulhall v. Quinn, 67 Mass. (1 Gray) 105, 107 (1854); O'Neil v. Helmke, 124 Wis. 234, 237, 102 N.W. 573, 574 (1905); see also supra note 172 and accompanying text; U.C.C. § 9-204 comment 1; E. FARNsworth, supra note 3, § 11.5, at
A creditor relying on a common law pledge faces the same constraints as the assignee. A contract to pledge an intangible not yet in existence will at most create an equitable interest. If the deposit account in example 3 is pledgeable, the outside creditor would acquire only an equitable interest in the $5,000 deposit, which would be subordinated to the interest of a lien creditor who without notice of the equitable interest extended credit to the depositor. In contrast, if the outside creditor held a properly perfected article 9 security interest covering after-acquired deposits, it would prevail over the lien creditor.

Article 9 limits the enforceability of "after-acquired property" clauses against consumer goods. Specifically, the secured party cannot contract for an interest in consumer goods acquired by the debtor more than ten days after the loan is made. This restriction protects the unsophisticated consumer-borrower from encumbering all present and future personal property in exchange for a single advance. The preservation of a "cushion" of free assets also benefits subsequent competing creditors.

770-71 n.21; 1 G. Gilmore, supra note 19, § 7.12; Restatement (Second) of Contracts § 330 comment d (1979).

198. See Restatement of Security § 10(3) (1941).

199. See id. § 10 comment e, illustration 6.

200. U.C.C. § 9-301, by negative implication, makes a perfected security interest senior to an execution lien. See U.C.C. § 9-301(1)(b), (3). In example 3, the article 9 creditor's interest would be perfected at the instant the depositor obtained rights in the collateral—the depositor's chose in action against the depositary bank. See id. §§ 9-204(1), -302(1)(c), -303(1). Accordingly, the article 9 creditor's interest would be perfected from the moment the $5,000 was deposited on Day 3, before the lien creditor garnished the account. For a discussion of other priority disputes, see infra text accompanying notes 279-373 and 374-440.

201. See U.C.C. § 9-204(2).

202. More precisely, despite the presence of an "after-acquired property" clause in the security agreement the security interest will not "attach" to the later-acquired consumer goods. See id.

Under U.C.C. § 9-204(2), the 10-day period begins to run when the creditor gives "value," which could occur as early as when the creditor makes a "binding commitment to extend credit." Id. § 1-201(44)(a).

203. Cf. U.C.C. § 9-204(2) comment 2. Professor Gilmore explains that the case for a relatively unrestricted "floating lien" against the property of a business debtor "rests not so much on the merits or the positive excellence of the floating lien as on an argument of fait accompli." 1 G. Gilmore, supra note 19, § 11.7, at 360. As illustrated by the examples in this Article, the common law right to set-off permits the creditor in some cases to reach more of the depositor's assets and in other cases less. The primary advantage of the article 9 floating lien in the business context is that the terms of the security agreement define the lien's dimensions, and depositary institutions must compete with other creditors to obtain these broad rights against the depositor's present and future deposit account collateral.
A similar provision could be enacted restricting after-acquired interests in consumer deposit account collateral, as illustrated in example 4 below. Despite an after-acquired deposit clause, no security interest in a deposit account used “primarily for personal, family or household purposes,” would attach to subsequent deposits made more than ten days from the time the secured party gave “value.”

Example 4:
The depositor has a $10,000 deposit account used for personal and family expenses. No third party has an interest in the account. The depositor grants the depositary bank a security interest in $3,000 of the account to secure a $2,000 loan. The security agreement includes an “after-acquired deposit” clause. The following activity occurs:
Day 1: The account has a balance of $10,000 and the depositor receives the $2,000 loan proceeds.
Day 2: The depositor withdraws $9,000, leaving a balance of $1,000.
Day 15: The depositor deposits $5,000 of wholly owned funds, leaving a balance of $6,000.

Under the proposed expanded article 9 the bank, using self-help procedures, could foreclose against only $1,000—the lowest intermediate balance. The bank’s security interest would not attach to the subsequent deposit of $5,000 because it was made more than ten days after the $2,000 loan. In contrast, under the common law doctrine of set-off, the bank could collect $2,000.

Example 5:
The depositor has a $10,000 deposit account. No third party has an interest in the account. The depositor grants the depositary bank a security interest in $3,000 of the account to secure a $2,000 loan. The security agreement includes an “after-acquired deposit” clause. The following activity occurs:
Day 1: The account has a balance of $10,000.
Day 2: The depositor withdraws $9,000, leaving a balance of $1,000.
Day 3: The depositor deposits $5,000 of wholly owned funds, leaving a balance of $6,000.
Day 4: The bank makes a second advance of $10,000. No security agreement is executed with respect to this loan. The entire amount is deposited in the account, leaving a balance of $16,000.

In this example, the depositor owes the bank $2,000 on the first loan and $10,000 on the second loan. Should the debtor default on both loans, under an expanded article 9 the bank could foreclose on only $2,000 because the depositor has not agreed to secure the second loan of $10,000 with the deposit account. Under the common law of assignments or pledge, the bank also could foreclose on only $2,000, and then only if the depositor ex-
executed a second assignment or made a subsequent pledge of the after-acquired deposits.206

But if the bank asserts its common law right to set-off, it can use self-help foreclosure to recover the full $12,000 owed; the parties are mutually indebted to that extent at the time of default. To come out as well under article 9, the bank would have to persuade the depositor to include a "future advances clause" in the security agreement, as illustrated in example 6 below. Whether such a clause would be effective in an assignment, however, is problematic.

3. Changes in the Account Where There is a "Future Advances" Clause

The following example illustrates how a bank with an article 9 security interest in a deposit account as original collateral could ensure that subsequent credit advanced to the debtor is secured by the original deposit account.

Example 6:
The depositor has a $10,000 deposit account. No third party has an interest in the account. The depositor grants the depositary bank a security interest in $3,000 of the account to secure a $2,000 loan. The security agreement includes a "future advances" clause, but no "after-acquired deposit" clause. The following activity occurs:
Day 1: The account has a balance of $10,000.
Day 2: The depositor withdraws $9,000, leaving a balance of $1,000.
Day 3: The depositor deposits $5,000 of wholly owned funds, leaving a balance of $6,000.
Day 4: The bank makes a second advance of $10,000. The entire sum is deposited in the account, leaving a balance of $16,000.

On Day 4, the depositor owes the bank $12,000. Moreover, both loans are secured by the deposit account because of the "future advances" clause. But, given the absence of an "after-acquired deposit" clause, the secured creditor can extrajudicially foreclose on only $1,000 because the deposits of $5,000 and $10,000 on Days 3 and 4 do not augment the encumbered property. If both a "future advances" and an "after-acquired deposit" clause were included, however, the secured creditor could collect $12,000 out of the account.

Under the common law of assignments, the prudent outside creditor, to ensure that its "future advances" clause would be given full effect, would make a binding commitment in the original security agreement specifying when the future advances would be made and in what amount.207 In the ab-

206. See supra notes 195-99 and accompanying text.
207. Article 9 provides that an advance is made "pursuant to commitment"
sence of such provisions, the creditor would risk nonenforce-
m ent of the future advances clause and subordination of its
claim to a competing claimant who acquired rights after the
original but before the later advance. The "future advances"
clause in an article 9 transaction, on the other hand, is effective
without such a specific binding commitment.

The depositary institution asserting its common law right
to set-off would have the easiest time of all. It could recover
$12,000 without ever bargaining with the depositor about after-
aquired deposits or security for future advances. In addition,
the bank could set-off against the debtor's other deposit ac-
counts in the bank, and might even be able to set-off against
the debtor's accounts in the bank's other branches. Presum-
ably the bank would foreclose against the account that is least
profitable for it. For example, the bank might set-off against
the deposit account with the highest "locked in" interest rate or
with the largest penalty for early withdrawals. Under the pro-
posed expanded article 9, the bank's discretion would be lim-
ited by the terms of the security agreement. If the right to set-
off were not abolished, the depositary institution could circum-
vent the terms of the security agreement by relying on this "eq-
uitable" doctrine.

4. Changes in Deposit Account Collateral Attributable to the
Depositor's Disposition of the Collateral

A debtor's disposal of collateral encumbered by an article 9
security interest raises two issues concerning the scope of the
secured party's rights: first, whether the security interest con-
tinues in the original collateral—even after the collateral has
passed from the debtor to a third party; and second, whether

when the creditor "has bound himself to make it, whether or not a subsequent
event of default or other event not within his control has relieved or may re-
lieve him from his obligation." U.C.C. § 9-105(1)(k). The term is used in the
same sense in the accompanying text; such a binding commitment is a promise
that would be consideration for a return promise.

208. See U.C.C. § 9-204 comment 5; 1 G. Gilmore, supra note 19, §§ 35.3-4.

209. U.C.C. § 9-204(3) states that "[o]bligations covered by a security agree-
ment may include future advances . . . whether or not the advances . . . are
given pursuant to commitment." See also id. § 9-312(7).

210. See generally Comment, The Right of Set-Off Against a Branch Bank,
35 Fordham L. Rev. 712 (1967); supra note 14.

211. A court might construe the security agreement as a contractual limit
on the equitable right to set-off. But whether it would so hold presumably
would turn on the language of the security agreement in question. There
would be no such uncertainty if the now-obsolete common law right were
abolished.
the secured party has an interest in the "proceeds" received by
the debtor in exchange for the original collateral. The same
two issues arise with deposit account collateral. When a depos-
itor writes a check on its account or withdraws cash to
purchase goods or services, does the secured party have a con-
tinuing security interest in the original collateral (the deposit
account funds—now transformed into a check or cash) in the
hands of the third party?212 In other words, can the secured
party "trace" its interest out of the deposit account?213 If the
third party exchanges property for the depositor's check or
money, is that property "proceeds" in the hands of the deposi-
tor, subject to the interest of the secured party?214 With minor
modifications, article 9's provisions would answer these ques-
tions consistent with sound policy.

a. The Continuing Security Interest in Original Collateral

Section 9-306(2) provides that "a security interest contin-
ues in [original] collateral . . . unless the disposition was au-
thorized by the secured party in the security agreement or
otherwise."215 Under most customer agreements, a depositor is
allowed to write checks, withdraw funds, and redeem certifi-
cates of deposit. Although a penalty may be imposed if such
action reduces the balance below an established minimum, ab-
sent an express restriction in the security agreement or an un-
usual past course of dealing between the depositary insti-
cution

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212. The original collateral is the depositor's chose in action against the de-
positary bank, as reflected by the balance shown on the bank's records. When
the depositor writes a check, the original collateral takes two forms: the re-
duced chose in action against the bank and the formalized order of the deposi-
tor/drawer directing the bank to pay eventual holders of the check. See U.C.C.
§§ 1-201(12), 3-104. Similarly, where the depositor withdraws funds, the original
collateral is transformed into money and a reduced chose in action. Thus,
when the depositor subsequently uses a check or withdraws cash to purchase
an asset, the acquired asset is "first generation proceeds." The question raised
in the text is whether the secured party has an interest in the check or money
in the hands of the seller of the asset.

The Code's definition of "proceeds" is very broad. See U.C.C. § 9-306(1). One
could characterize the depositor's receipt of withdrawn funds or a check in
exchange for diminution of the deposit account balance as the receipt of "first
generation proceeds." That conceptualization of the transaction, which is not
adopted in this Article, would not change the subsequent analysis.

213. See generally 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, 144, 152 (discussing rights of secured party against recipients of payments
from account).

214. See U.C.C. § 9-306 ("proceeds"; secured party's rights on disposition of
collateral).

and the particular customer the above-described reductions in the account would be "authorized" by the secured party within the meaning of section 9-306(2). Accordingly, the security interest would automatically terminate and the third party would receive the check or cash free of encumbrance.

If the disposition of the collateral is not authorized, section 9-306(2) provides that the security interest continues in the original collateral into the hands of the third person, "[e]xcept where this Article otherwise provides." Sections 9-307, 9-308, and 9-309 provide "otherwise" where the third party is a bona fide purchaser.

A provision should be added to article 9 specifying precisely when a third party can receive an unauthorized payment out of an encumbered deposit account free of the security interest. An official comment to the Code suggests that the "proceeds" interest of a secured party in an unauthorized pay-

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216. See, e.g., Kinetics Technology Int'l Corp. v. Fourth Nat'l Bank, 705 F.2d 396, 402 (10th Cir. 1983) (purchaser took free of bank's earlier perfected security interest because sale of collateral was authorized by secured party); United States v. Central Livestock Ass'n, 349 F. Supp. 1033, 1034 (D.N.D. 1972) (course of conduct manifested consent by creditor); Poteau State Bank v. Denwalt, 597 P.2d 756, 759 (Okla. 1979) (authorization may but need not be in security agreement). In this respect, deposit account collateral is similar to inventory. When a creditor engages in inventory financing, it knows that its collateral is held by the debtor primarily for later sale to third parties. In order to protect itself from the inevitable "erosion" of its collateral as the debtor operates its business, the creditor obtains a "floating lien"; the security interest attaches to new supplies of after-acquired inventory received by the debtor, to returned or repossessed inventory, and to proceeds received by the debtor when it sells present inventory. Advances are often made in the form of a line of credit covered by a "future advances clause." By keeping accurate records, and "policing" the debtor, the creditor will ensure that the ratio of the amount of credit outstanding to the value of the inventory in the hands of the debtor at any one moment does not exceed an acceptable "debt/collateral" ratio, often specified in the security agreement. See B. CLARK, supra note 44, ¶ 10.5[1].

If a creditor were to make a loan based on deposit account collateral, it could discover the terms of the deposit agreement, including the debtor's authority to draw down the account. If concerned about the diminution of its security, the deposit account financier also could take a "floating lien." See supra text accompanying notes 171-236.

217. See generally B. CLARK, supra note 44, ¶ 3.4 (discussing U.C.C. § 9-307(1)).

218. U.C.C. § 9-306(2).

219. The Code has no provision that specifically and comprehensively addresses the contest between a third party paid out of a deposit account and an earlier creditor claiming a security interest in the deposit account as original collateral.

Section 9-307 is not directly applicable—it protects various bona fide purchasers of goods from the interests of earlier secured parties in the same property as original collateral. Whether the original collateral here is categorized as the money withdrawn, see U.C.C. § 1-201(24), the check used as payment (an
ment out of a checking account should be cut off in favor of a third party who receives such payment in exchange for value given to the depositor in good faith and without notice. A liberal definition of what type of third party qualifies as a bona fide purchaser in this context is necessary. Otherwise, application of article 9 to deposit account collateral could prejudice third parties, thereby undermining the negotiability of checks and the free use of funds withdrawn from depository institutions.

The new section could provide, for example:

"instrument" under id. § 9-105(i)), or the deposit account, see id. § 9-105(e), it clearly is not a "good" within the meaning of article 9, see id. § 9-105(h).

The Code does provide an answer if a check is used to pay the third party. As long as the recipient qualifies as a "holder in due course," see id. § 3-302, or is a "purchaser in the ordinary course of business" who gives "value," the holder or purchaser takes priority over the earlier security interest in the check, see id. §§ 9-308(a), -309. Article 9 makes it clear that the mere fact that the creditor with the earlier security interest has filed a financing statement does not give the later recipient of the instrument "constructive notice," destroying its status as a bona fide purchaser. See id. §§ 9-308, -309.

220. Official comment 2 to U.C.C. § 9-306 states:

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.

Id. comment 2(c) (emphasis added).

221. As has been noted in the context of the battle between an earlier secured party claiming a "proceeds" security interest in the general account and a later third party recipient of a payment out of the same account, the rights of the third party should not turn on the form of the payment—whether cash or check—but rather on whether the third party is a bona fide recipient. See Skilton, supra note 213, at 150-51. California, which recognizes article 9 security interests in deposit accounts as original collateral, see supra note 22, has not enacted any special article 9 provision to resolve this problem.

222. Consider the problems that confront an appliance retailer receiving cash and check payments from its customers. If notice could be imputed to the retailer based on earlier creditors' filings against customer deposit accounts, the retailer would have to search the public records for earlier deposit account encumbrances before closing every sale. If a security interest were discovered, the retailer would have to investigate further. If the proposed payment were in cash, the retailer would need to ascertain whether the funds used had been withdrawn from the deposit account; if the proposed payment were by check, the retailer would have to determine whether the earlier secured party had "authorized" the payment. See supra notes 215-17 and accompanying text. Even if the payment were authorized, the retailer would have to apply common law tracing rules to calculate whether the actual funds that would be received in payment were encumbered. See supra text accompanying notes 171-236.

223. A central policy underlying articles 3 and 4 of the Uniform Commercial Code is to promote the free flow of negotiable instruments.


225. See Skilton, supra note 213, at 145-52.
In the case of any payment by the debtor out of deposit account collateral, the payee takes free of a security interest created by the debtor even though the security interest is perfected and even though the payee knows of its existence, if the payee receives the payment in good faith and for value. 226

Such a provision in conjunction with section 9-306(2) would prevent secured parties with interests in deposit accounts either as original collateral or as proceeds from tracing their security interests into funds held by third parties. Presently, depositary institutions have no common law right to set-off against funds disbursed by the depositor. 227

b. The Security Interest in Assets Purchased by the Depositor with Funds Taken from the Encumbered Deposit Account

Section 9-306(2) provides that irrespective of whether the sale of collateral is authorized by the secured party, the security interest "continues in any identifiable proceeds . . . received by the debtor." 228 The Code presumes that the security agreement, unless it expressly provides otherwise, gives the creditor a security interest reaching such "proceeds." 229 "Proceeds" are defined broadly to include "whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds." 230

Where the original collateral is the "deposit account" (or the check or cash into which it has been transformed), the first generation "proceeds" are the assets received by the debtor in exchange for payments out of the account. Under this Article's proposal, if those assets are "identifiable"—that is, if the secured party can show that the assets were purchased with encumbered deposit account funds—they are "proceeds" subject to the security interest under article 9. 231

Such an application of article 9 in place of the common law

226. This recommendation combines language from both the article 1 definition of a "buyer in ordinary course of business," see U.C.C. § 1-201(9), and § 9-307's protection of bona fide purchasers of goods claimed to be encumbered by the interests of earlier secured creditors, see id. § 9-307(1). Because of the importance of payments by check and of funds withdrawn from bank accounts in nonbusiness transactions between the debtor and third parties, no requirement is included that the depositor make the payment out of the account in the "ordinary course of business." See Skilton, supra note 213, at 152.
227. The third party recipient of the funds is not "mutually indebted" with the bank. See supra text accompanying note 159.
228. U.C.C. § 9-306(2).
229. Id. § 9-303(3).
230. Id. § 9-308(1).
231. See Skilton, supra note 213, at 152.
would sometimes enhance, rather than diminish, a depositary bank's self-help remedies. Business and consumer customers frequently maintain general bank accounts in order to have a safe and convenient way of paying for purchases. Creditors' interest in first generation "proceeds" paid for by check could provide an additional incentive for their reliance on deposit account collateral. In contrast, a bank exercising its common law right to set-off has no claim beyond the balance remaining in the account upon default.

There are, however, important restrictions on this interest in proceeds. Section 9-306(2) requires that the proceeds be "identifiable." To meet this requirement, the secured party would have to establish that the purported "proceeds" were purchased with funds from the encumbered deposit account.

In addition, the secured party would have to demonstrate that the deposit account funds used to purchase the proceeds were subject to the creditor's original security interest under the lowest intermediate balance rule. The following examples illustrate how these factors could reduce the secured party's claim against assets purchased with deposit account funds.

Example 7:
A business depositor has a $10,000 deposit account. No third party has an interest in the account. The depositor grants the bank a security interest in $3,000 of the account to secure a $2,000 loan. The following activity occurs in the account:
Day 1: The account has a balance of $10,000.
Day 2: The depositor withdraws $9,000 for payment of employee salaries, leaving a balance of $1,000.
Day 3: The depositor purchases a typewriter for $500, paid for by a check drawn on the deposit account.

On Day 2, the bank had a security interest of $1,000 under the lowest intermediate balance rule. Although $2,000 of "encumbered funds" were used to pay employee salaries, no asset was purchased to which a security interest in proceeds could attach. Following the purchase of the typewriter on Day 3—made with "encumbered" funds—the bank had a security interest in deposit account collateral of only $500 and a security interest in the $500 typewriter as proceeds.

232. In some cases, this element would be relatively easy to establish. If payments were made by check, the secured creditor could simply produce the cancelled check. If payment were made in cash, the secured creditor might introduce evidence establishing that on the day of the purchase the debtor withdrew funds from the encumbered account in an amount that approximates the purchase price of the asset claimed as proceeds.
233. See supra text accompanying note 179.
234. Under the common law, the bank with a right to set-off would only re-
In the next example, "encumbered" funds are commingled with "unencumbered" funds at the time the asset is acquired.

**Example 8:**
A business depositor has a $10,000 account. No third party has an interest in the account. The depositor grants the bank a security interest in $3,000 of the account to secure a $2,000 loan. There is no "after-acquired deposit" clause in the security agreement. The following activity occurs in the account.

- **Day 1:** The account has a balance of $10,000.
- **Day 2:** The depositor withdraws $9,000 to pay employee salaries, leaving a balance of $1,000.
- **Day 3:** The depositor deposits $5,000 of wholly owned funds, leaving a balance of $6,000.
- **Day 4:** The depositor purchases a computer for $5,500, paid for by a check drawn on the account.

Immediately prior to the purchase of the computer on Day 4, the bank had a security interest of $1,000 under the lowest intermediate balance rule. Money paid out of the account is presumed to come first from unencumbered funds; thus only $500 of the purchase price came from "encumbered" funds. Accordingly, the bank would have a $500 security interest in the deposit account as original collateral and a $500 security interest in the computer as proceeds—an equitable outcome.

As shown in the preceding eight examples, if the common law of assignments and pledge, as modified by statute, and the doctrine of set-off are displaced, article 9 could provide a workable legal framework within which an individual debtor and its creditors could bargain concerning the dimensions of the security interest granted in deposit account collateral. If a business debtor were willing to give the secured creditor a "floating lien" over deposit account collateral, the security agreement could so provide by the inclusion of "after-acquired deposit" and "future advances" clauses. On the other hand, if the debtor were to conclude that the size of the advance, the terms of the repayment, or other factors warranted the grant of a less expansive interest, such clauses could be omitted from the security agree-
ment and an express waiver of the secured party's interest in proceeds could be included.

C. Perfection of the Security Interest in Deposit Accounts as Original Collateral

Creditors bargain for security interests in collateral to increase the likelihood that they will be repaid should the debtor default. Unlike general creditors, article 9 secured parties have a claim to specified items of the debtor's personal property to cover the balance owed. There may, however, be competing creditors of the debtor holding security interests, statutory liens, or judicial liens against the same personal property. Before entering into a transaction, a potential creditor thus will want to know how its interest ranks against the conflicting interests of others.

Under article 9, a creditor who creates a security interest and gives the requisite public notice obtains the “exalted” status of a creditor holding a “perfected” security interest. Depending on the type of collateral, a creditor ordinarily “perfects” either by filing a financing statement in the appropriate state office or by taking possession of the collateral. The general rule is that the first creditor to give public notice, and thus perfect its security interest, has priority over all competing creditors. Once such notice has been given, subsequent creditors who rely on the same collateral do so at their peril. If prudent, they will discover the earlier security interest and charge a higher interest rate to cover their enhanced risks upon default, negotiate a subordination agreement with the earlier creditor, ask for additional collateral, or simply decide not to extend credit. Similarly, potential purchasers of the encumbered personal property from the debtor can discover the earlier credit transaction and adjust their behavior to protect their interests. Thus, the debtor's opportunity to defraud third parties by claiming full ownership of already encumbered personal

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237. See Baird & Jackson, supra note 57, at 179.
238. See U.C.C. §§ 9-502 to -505.
239. Baird & Jackson, supra note 57, at 175-76, 179.
240. See B. CLARK, supra note 44, § 1.2[2].
241. See U.C.C. § 9-303(1).
242. See id. §§ 9-302(1), -401, -402.
243. See id. § 9-305.
244. See id. § 9-312(5)(a). But see id. § 9-312(3), 9-312(4) (exceptions to this rule).
property will be diminished.246

These public notice requirements and first-in-time priority rules should also be applied to the proposed article 9 security interest in deposit accounts as original collateral. The present law places the risk of "ostensible ownership" of deposit accounts on the subsequent creditor to a substantially greater extent than does article 9. Under the common law, a depository institution has no obligation to warn subsequent creditors or purchasers of its inchoate right to set-off. Pledge transactions afford public notice by requiring the debtor to relinquish possession of indispensable writings, thus making it difficult for the pledgor to obtain "false credit from apparent ownership of the pledged property." In many states, however, the debtor can avoid this restriction if the creditor accepts a security assignment rather than a pledge. An assignee of either an incorporeal or reified deposit account need not give general public notice to protect its interest against successive claimants.249 Although in California and Hawaii the Code has been modified to authorize retention of an article 9 security interest in all deposit account collateral, the secured party has no obligation to provide general public notice.250

246. See Baird & Jackson, supra note 57, at 175-90.
249. See E. Farnsworth, supra note 3, § 11.9; Restatement (Second) of Contracts § 342 comment a (1979).
250. The California statute provides in pertinent part:

(1) A financing statement must be filed to perfect all security interests except the following: . . . (g) A security interest in a deposit account. Such a security interest is perfected: (1) As to a deposit account maintained with the secured party when the security agreement is executed; (2) as to a deposit account not described in subparagraph (1) when notice thereof is given in writing to the organization with whom the deposit account is maintained.

CAL. COM. CODE § 9302(1)(g) (West 1984); see also HAWAII REV. STAT. § 480-302(h) (1983).

The rationale for giving notice to the depository institution is traceable to the common law. Under the law of assignments, absent such notice the obligor (the depository bank) can continue to make payments to the principal debtor (the depositor) without incurring any risk of double liability. See Restatement (Second) of Contracts § 170(1) (1979). The same rule is carried forward into California's and Hawaii's versions of article 9. See U.C.C. § 9-318(3).

In addition, by providing such notice to the depository bank the outside creditor will prevent the bank from subsequently foreclosing against the funds that by virtue of the notice may be transformed from a "general" account to a "special" account. See Annot., 8 A.L.R.4th 998, § 4 (1981). There is no right to set-off against "special" accounts. Id.
To justify departing from the common law, one must carefully examine both the benefits and costs of the article 9 public notice requirements in the specific context of deposit account collateral. Such an analysis must first address the difficult issue of how public notice would be given, if required. The Code could treat all deposit accounts as "general intangibles" and provide that a security interest in a deposit account could be perfected solely by filing a financing statement.\textsuperscript{251} Alternatively, the Code could distinguish between deposit accounts represented by symbolic writings and all other deposit accounts. As to the former, the Code could either require that the secured party take possession of the writing symbolizing the depositor's chose in action or could allow the parties to choose either possession or filing. As to the latter, the incorporeal accounts, filing would be the only permissible mode of perfection.

The "perfection by possession" alternative should be eliminated, leaving filing as the only method of perfecting article 9 security interests in deposit accounts as original collateral.\textsuperscript{252} Creditors, debtors, and courts would no longer need to determine which deposit accounts are represented by symbolic writings, an increasingly difficult task with electronic funds transfers and a wide variety of deposit arrangements.\textsuperscript{253} In addition, there would be no need to ascertain when the debtor had relinquished sufficient control to transfer possession.\textsuperscript{254} The Code defines precisely what constitutes an effective filing.\textsuperscript{255} Moreover, filing provides better and more accessible public notice to potential creditors and purchasers than does perfection by possession.\textsuperscript{256}

If perfection can only be accomplished by filing, then deci-

\textsuperscript{251} See U.C.C. §§ 9-106, -302(1).

\textsuperscript{252} Recent articles argue persuasively that perfection by filing is superior to perfection by possession. See, e.g., McDonnell, \textit{A Reevaluation of Public Notice Under Article 9 of the Uniform Commercial Code}, in 1A P. COOGAN, W. HO\textsc{g}AN & D. VAGTS, supra note 5, §§ 6C.01-6C.08; Coogan, supra note 140; Phillips, \textit{Flawed Perfection: From Possession to Filing Under Article 9} (pts. 1-2), 59 B.U.L. Rev. 1, 209 (1979).

\textsuperscript{253} Litigation thus could be avoided over whether perfection was accomplished by delivery of a checkbook, a debit card, or a nonnegotiable certificate of deposit (generally the size of a check and without "seals, ribbons, [or] gilded edges"). See Harris, supra note 25, at 373 n.191.

\textsuperscript{254} See Phillips (pt. 1), supra note 252, at 24-28.

\textsuperscript{255} See U.C.C. § 9-403(1) (filing occurs when the creditor presents the financing statement and tenders the filing fee).

\textsuperscript{256} See Coogan, supra note 140, at 1033-36; Phillips (pt. 1), supra note 252, 34-43.
sions concerning control of the deposit account during the loan repayment period could be based on the business needs of the depositor and the creditors' assessment of the risks of the transaction. If the depositor had a short-term liquidity problem, the original secured party might allow hypothecation of an interest in the same account to a less risk-averse creditor; that subsequent creditor also could file to obtain a perfected, but junior, security interest. In contrast, if possession of an indispensable writing were required for perfection, the debtor would have to meet its additional financing needs by negotiating with the original secured creditor for a future advance, by purchasing credit elsewhere at a higher unsecured rate, or by persuading the original creditor to enter into a subordination agreement with the later creditor. Such measures would be needlessly costly and inconvenient, particularly where the original creditor was overcollateralized.

If the depositor remains in control of the encumbered deposit account, both the proceeds of the loan and the “collateral funds” to the extent allowed by the loan agreement can be used in the depositor's business. Efficient and good faith use of resources by the business debtor best ensures repayment of the loan. Moreover, under article 9, unlike the common law, the secured creditor who perfects by filing could retain a floating lien that would encumber equipment or inventory purchased with deposit account funds.

Proponents of “perfection by possession” rely on its prevalence in current commercial practice. Professor Phillips has
pointed out the circularity of this reasoning: lenders take possession because the current law affords them maximum protection of their interests if they do so. Surely, the Code need not blindly follow practices developed when banking transactions were tied to paper-based formalities. By eliminating the "perfection by possession" alternative, the parties could decide in each transaction who could best use the collateral during the loan repayment period.

The benefits of requiring filing in the deposit account context would outweigh the costs involved. A depositor left in possession of a deposit account will ordinarily exercise broad control with only minimal restrictions. Because these restrictions do not ordinarily apprise potential creditors of the earlier encumbrance, the depositor has the opportunity to misrepresent ownership of the collateral. If the transaction costs of filing are minimized, the imposition of article 9 filing requirements on deposit account financing could improve the functioning of credit markets by enabling all participants to consider all the risks in their decisionmaking.

Numerous potential creditors will need information about prior security interests in deposit accounts. A creditor plan-

263. See Phillips (pt. 2), supra note 252, at 239.

264. Article 9 contains exceptions to the public notice requirement where the costs to the secured party of filing or taking possession of the collateral outweigh the benefits to later creditors. See Baird & Jackson, supra note 57, at 190-94. For example, § 9-302(1)(d) provides that a purchase money security interest in consumer goods is automatically perfected at the time of attachment. See U.C.C. § 9-109, -302(1)(d). The justifications for this exception are that the cost of filing in a multitude of individual retail transactions is great and that the relatively inexpensive, rapidly depreciating encumbered goods are not likely to serve as collateral for subsequent creditors. See Baird & Jackson, supra note 57, at 192-93 (articulating this justification and expressing reservations); see also B. Clark, supra note 44, ¶ 2.7[1].

It is difficult to predict whether there would be a substantial secondary market for financing against deposit accounts. If the balance in the account were substantial, subsequent creditors might be extremely interested in this additional source of collateral, which will not depreciate, so long as information about the existence and dimensions of earlier encumbrances is readily available.

265. For example, the depositor's freedom is limited by bank rules concerning service charges, deposits, and withdrawals. Article 4 provides additional limitations on the bank's obligation to comply with the depositor's directions. See, e.g., U.C.C. §§ 4-303(1), -404.

266. Under the present system, a subsequent creditor needs, but may not have, information about the depositary institution's right to set-off. This is the case whether the subsequent creditor has a security interest in proceeds in a deposit account or is unsecured and thus must look to the debtor's general assets (including deposit accounts) for ultimate satisfaction of its claims. See infra text accompanying notes 267-69.
ning to retain a security interest in the deposit account as original collateral will obviously want to discover earlier encumbrances. An inventory financier considering a debtor's request for unrestricted use of cash proceeds during the loan repayment period needs to know whether the deposit of such proceeds in the debtor's general bank account will affect the priority of its security interest.\(^\text{267}\) A creditor contemplating an unsecured advance may look to the article 9 files for supplemental information about the debtor's general financial well-being. If such creditors examine financing statements indexed under the debtor's name\(^\text{268}\) and discover that all deposit accounts have been hypothecated, they may change the terms of their offers.\(^\text{269}\)

All of these creditors, of course, could question the debtor or rely on "private markets" for information about the debtor's earlier transactions.\(^\text{270}\) For instance, if the depositary institution is the potential creditor, it could include a term in the depositary agreement requiring disclosure by the debtor of all transactions secured by the deposit account. But the reason for the article 9 public notice requirement is to provide information from a source other than the debtor—the potential perpetrator of fraud.

If the subsequent creditor is an outside creditor, it may be able to discover the whereabouts of the debtor's different deposit accounts and question each depositary institution concerning encumbrances.\(^\text{271}\) But those depositary institutions may be unaware of the encumbrances of other creditors. Moreover, they may be unwilling to divulge what they do know for fear of potential liability\(^\text{272}\) or loss of customer goodwill. Depositary institutions have no common law duty to provide such

\(^{267}\) See infra text accompanying notes 310-32.

\(^{268}\) See U.C.C. § 9-403(4).

\(^{269}\) Professor Phillips, arguing for elimination of perfection by possession, points out that even if unsecured creditors do not actually check article 9 files themselves, "most likely the debtor's accountants, institutional creditors and credit agencies do check such filings before preparing or certifying any statements, extending credit, or transmitting or formulating any credit rating to interested parties." Phillips (pt. 1), supra note 252, at 39. In this indirect way, the public filing system may help trade creditors test the validity of debtors' representations about their financial well-being. Id.

\(^{270}\) See Baird & Jackson, supra note 57, at 182-83.

\(^{271}\) In the case of a debtor with numerous deposit accounts in different institutions, this task would be expensive and time-consuming, particularly when contrasted with a search of article 9 files under the debtor's name.

\(^{272}\) In part because of the reluctance of creditors to divulge such information, the Code sets up a procedure whereby a potential creditor, with the help
In addition, they may have economic reasons to not report the extent of customer indebtedness accurately. If a bank, for example, believes its depositor can no longer operate profitably without inventory financing from the inquiring creditor, the bank may understate the extent of the depositor’s outstanding obligation. On the other hand, if the depositary institution fears that the debtor is overextended, or if the bank is competing with the outside creditor for the opportunity to extend a future advance, it may overstate outstanding obligations.

In the absence of a reliable and convenient source of information, all potential creditors may charge a premium for lending based on the conservative assumption that deposit accounts are encumbered. Such behavior would not maximize the interest of the honest debtor, the honest depositary institution, or the honest outside creditor.

The article 9 public filing system provides “concrete and trustworthy” information which creditors may use to supplement knowledge gained through private sources. Certain factors suggest that the costs would not be excessive. The article 9 filing system is already in place for other types of collateral—there are detailed rules concerning the requirements for the financing statement, where it must be filed, how it should be indexed, the consequences of errors, and how the statement can be amended, terminated, or continued. State offices are

of the debtor, can demand information about the amount outstanding on the earlier loan and the extent of the encumbrance. See U.C.C. § 9-208.

Banks have incurred liability for fraud and deceit or negligent misrepresentation for providing erroneous or incomplete information about a depositor’s creditworthiness and thereby inducing third parties to extend loans or make credit sales. See 5B Michie, supra note 32, § 312 (1983); Annot., 77 A.L.R.3d 6 (1977). In order to establish a case of intentional fraud, the following factors must be established:

1. a misrepresentation or an omission of a 2. material 3. fact; (4) knowledge or belief on the part of the bank . . . that the misrepresentation is false, misleading, or incomplete; (5) an intention to induce the plaintiff to act or refrain from acting in reliance on the representation; and (6) justifiable or reasonable (7) reliance to the plaintiff’s (8) detriment.

77 A.L.R.3d at 14. To establish negligent misrepresentation, the scienter requirement (factor (4) above) is “speaking about . . . creditworthiness in a reckless or negligent manner.” Id. at 14.

273. 5B Michie, supra note 32, § 308, at 222 (1983).

274. As explained by Professors Baird and Jackson, information given through public filings is “trustworthy” because the information is “conveyed” by the occurrence of an “event”—the filing or its absence. Baird & Jackson, supra note 57, at 184.

275. See, e.g., U.C.C. § 9-401 to -404, -406.
established, indexing systems exist, and creditors have developed the necessary forms. A creditor retaining a security interest in more traditional collateral as well as deposit accounts could prepare a single financing statement, describing all the collateral, and would pay only one, minimal filing fee.\textsuperscript{276}

At present no study has been made concerning the actual costs of filing to creditors and to the state\textsuperscript{277} accordingly, a legislature might experiment for a trial period with a full filing requirement for deposit account collateral. If costs proved excessive, the legislature could establish a more limited notice system. For example, filing could be required only for extensions of credit secured by deposit accounts of $1,000 or more, or for advances with repayment periods exceeding ninety days.\textsuperscript{278}

For the remainder of this Article, it is assumed that filing is re-


\textsuperscript{277} The state's overhead costs might increase because of the larger volume of filings. Some of these costs could be passed on to creditors in the form of increased filing fees. Some of the costs to creditors might be passed on to debtors. If states take advantage of improved computer technology, the costs could be minimized while creditors would have access to more information more rapidly. See Coogan, supra note 140, at 1051-53.

In testimony before Congress in connection with the Bankruptcy Reform Act, lawyers representing a large association of bankers opined that bankers would not object to "footnoting" by accountants indicating which balances are subject to set-off. But when asked about article 9 filings, the bankers replied that "in that the vast majority of borrowers maintain balances" it "would pose great expenses to our economy and to whatever governmental agency would have the task of maintaining these records." \textit{Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., 2d Sess. 2508-09 (1976)} (testimony of John J. Jerome and David L. Bleich, Esqs.). No statistics were provided.

\textsuperscript{278} The amount of security would be reflected in the description of the collateral contained both in the security agreement and the financing statement. See supra notes 113-16 and accompanying text. A few states have modified the purchase money security interest in consumer goods exception to require filing where the loan is for more than a certain amount. See, e.g., Colo. Rev. Stat.
quired to perfect all security interests in deposit accounts as original collateral. The time of the filing will in large part determine the priority of the creditor's claim, as explained in the following section.

III. BASIC PRIORITY PROBLEMS

The article 9 drafters codified priority rules that earlier security statutes simply left to judges with little or no guidance.279 According to Professor Gilmore, the pre-Code law was inadequate both because of the difficulty of finding adequate legislative solutions and because many priority problems arose "in the no-man's land between the various security devices."280 As will be seen in the analysis of some illustrative priority problems below,281 article 9 resolves neither the conflict between a bank asserting its common law right to set-off and an article 9 creditor with a security interest in proceeds in a deposit account, nor the contest between such a bank and a creditor with a judicial lien against the account.282 If article 9 is expanded so that banks must create security interests in deposit accounts as original collateral, and cannot rely on the common law right to set-off, another "no-man's land" will be

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279. 1 G. GILMORE, supra note 19, at 655.
280. Id.
281. This Article does not discuss all the basic priority rules that would be affected. One important issue not addressed is whether the Code's rules providing priority to later-in-time purchase money security interests should apply to deposit accounts. See, e.g., U.C.C. § 9-312(3), (4). In the context of traditional collateral, there has been thoughtful criticism of these "superpriority" provisions. See generally Jackson & Kronman, supra note 245. The "conventional" explanation is that without these provisions the debtor would lose access to important secondary sources of credit. See B. CLARK, supra note 44, § 3.9[1]. In order to retain a "purchase money security interest" in deposit accounts, the creditor would advance funds which the debtor then would deposit in the account—in effect "purchasing" with the loan proceeds an augmented chose in action. See U.C.C. § 9-107. In the remainder of this Article, it is assumed that there should not be special rules favoring purchase money security interests in deposit account collateral.
282. The term "lien creditor" is used hereinafter to describe a creditor holding a judicial lien. See U.C.C. § 9-301(3) ("lien creditor" is "a creditor who has acquired a lien on the property involved by attachment, levy, or the like").
crossed and these and other priority problems will be resolved under article 9's general propositions.

A. The Priority Battle Between Two Creditors with Article 9 Security Interests in the Same Deposit Account as Original Collateral

In a classic priority battle, each competing creditor asserts that its interest in an item of the debtor's property is superior to that of the other claimant. The creditor who prevails has the right to full satisfaction of its claim out of the collateral before the subordinate creditor can obtain any satisfaction. This section examines a contest between two creditors with article 9 security interests in the same deposit account as original collateral. Should article 9 be amended as proposed, this priority problem could arise frequently because it would be more practicable for debtors to hypothecate deposit accounts to creditors other than to depositary institutions.283

Example 9:

The depositor has a $10,000 deposit account. The following activity occurs:

Day 1: The account has a balance of $10,000.
Day 2: The depositor grants the depositary bank a security interest in $3,000 of the deposit account as original collateral to secure a $5,000 loan. The security agreement includes an "after-acquired deposit" clause.
Day 3: The depositor grants a finance company a security interest in $5,000 of the account as original collateral to secure a $10,000 advance. The security agreement does not include an "after-acquired deposit" clause.
Day 4: The depositor withdraws $6,000 to pay wages, leaving a balance of $4,000.
Day 5: The finance company files a properly completed financing statement.
Day 6: The depositary bank files a properly completed financing statement.
Day 7: The depositor deposits $1,000 in its account, leaving a balance of $5,000.

In resolving this contest between the depositary bank and the finance company, it is useful to first determine to what extent these creditors' interests are in conflict.284 The size of each creditor's interest in the account on Day 7 should be indepen-

283. Article 9 already covers the priority battle between two creditors claiming security interests in proceeds traceable to a deposit account. See B. CLARK, supra note 44, § 1.8[12].

284. The same approach also could be used with traditional collateral. For example, if the resale value of an automobile is sufficient to satisfy the balance owed to each of two competing creditors, there is no need to determine which creditor is senior to the other.
dently calculated, ignoring the interest of the other. The depositary bank holds a perfected security interest in $4,000 of the $5,000 balance if one applies the lowest intermediate balance rule and ignores the interest of the finance company. If the bank's interest is ignored, the finance company also holds a perfected security interest in $4,000 of the $5,000 balance. Accordingly, the contest between the creditors is over $3,000; neither creditor can get more than $4,000 and each is assured a minimum of $1,000.

Rather than “inventing” a new rule to govern this basic priority dispute, the article 9 solution should be applied. Under section 9-312(5)(a), the first party to give “public notice” of its interest wins. Here the finance company, because it filed its financing statement first, would prevail as to the contested $3,000. Adding the $1,000 of uncontested funds, the finance company could foreclose on a total of $4,000 in the deposit account. As the junior creditor, the bank would take the remaining $1,000 for its debt. The finance company could sue the debtor for a deficiency of approximately $6,000 (assuming no repayment on the $10,000 loan) and the depositary bank could sue for approximately $4,000.

The justification for this “first-to-file” priority rule in disputes over deposit account collateral is the same as where traditional collateral is involved. Although the finance company in example 9 was the second creditor to advance funds, and may even have had “actual” knowledge of the depositary

285. See supra notes 177-79 and accompanying text.

286. On Day 2, the depositary bank had an interest in $3,000 of funds. The withdrawal of $6,000 on Day 4 is presumed to come first from funds not subject to the bank's interest. Because of the “after-acquired deposit” clause in the security agreement, see supra notes 171-72 and accompanying text, the bank's security interest automatically attaches to the $1,000 deposit on Day 7, leaving $4,000 of the $5,000 balance subject to the bank's encumbrance.

287. On Day 3, the finance company had an interest in $5,000 of funds. The withdrawal of $6,000 on Day 4, even if presumed to first come from funds not subject to the finance company's interest, reduces the finance company's claim to $4,000. Because there is no after-acquired deposit clause in the agreement, the finance company's interest is not augmented by the deposit on Day 7.

288. U.C.C. § 9-312(5)(a) provides in pertinent part: “Conflicting security interests rank according to priority in time of filing or perfection.”

289. See U.C.C. § 9-502(1).

290. See id. § 9-502(2).

291. See id. The finance company may also recover its “reasonable expenses of realization from the collections.” Id. In this case the finance company's reasonable expenses would reduce the depositary bank's share of the account.

292. See id.
bank's interest, it wins under article 9's "pure race" rule. The Code adopts this approach because it is simple, certain, and promotes reliance on public records. Both creditors are ordinarily professionals; the depositary bank could have protected itself simply by filing a financing statement on Day 2. In the absence of such a filing by the bank, the finance company had no reliable way to discover the earlier encumbrance before it extended credit on Day 3.

It may be tempting, with such easily divisible collateral, to prorate the contested amount of the deposit account. For example, the $3,000 could be allocated to the bank and the finance company according to the ratio of the unpaid balances on their two advances. But such an approach, by adding unnecessary complexity to an already complex set of common law rules, would not further the article 9 goal of creating a simple system of priorities based on public notice.

The next example shows how the above-described application of article 9's priority rule would make the law more certain and uniform than the common law of assignments or pledge.

**Example 10:**

The depositor has a $10,000 Money Market Deposit Account. The following activity occurs:

- **Day 1:** The account has a balance of $10,000.
- **Day 2:** The depositor grants a finance company a security interest in $6,000 of the deposit account as original collateral to secure an $8,000 loan.
- **Day 3:** The depositor grants a thrift institution a security interest in $9,000 of the deposit account as original collateral to secure a $10,000 loan.

293. See id. § 9-312 comment 5, example 2.
294. See B. CLARK, supra note 44, ¶ 3.8[1]; D. BAIRD & T. JACKSON, supra note 57, at 406-09 (any system taking into account the knowledge of the competing creditors may lead to circular priority problems, less information being added to the filing system, and difficulties for the debtor who tries to persuade a creditor to extend credit). But see Felsenfeld, Knowledge as a Factor in Determining Priorities Under the Uniform Commercial Code, 42 N.Y.U.L. Rev. 246 (1967).
295. See B. CLARK, supra note 44, ¶ 3.8[1].
296. The Code adopts such an approach with respect to original collateral that becomes part of a "product or mass." U.C.C. § 9-315. See 2 G. GILMORE, supra note 19, § 31.4, at 846-47 (difference between a "commingled mass," to which U.C.C. § 9-315 applies, and "commingled proceeds" governed by U.C.C. § 9-305).
297. Under such a rule, if the debtor had not repaid any part of either loan, the bank, because its loan accounted for one-third of the total indebtedness, would recover $2,000 ($1,000 of uncontested funds plus one-third of the contested $3,000); the finance company would recover $3,000 ($1,000 of uncontested funds plus two-thirds of the contested $3,000).
298. See supra note 294 and accompanying text.
Day 4: The thrift files a properly completed financing statement.
Day 5: The thrift formally notifies the depositary institution of its interest.

Were it not for the thrift institution, the finance company would have an interest in the Money Market Deposit Account in the amount of $6,000; were it not for the finance company, the thrift would have an interest of $9,000. Accordingly, there is a conflict over $5,000. Since it filed first, the thrift would prevail under article 9. It could foreclose on the account for $9,000; the finance company would obtain $1,000 from the account and sue for a deficiency of $7,000.

The result under the common law of assignments depends on where the dispute is heard. If the jurisdiction has adopted the "New York" rule, the result would be opposite that reached under article 9: the finance company (the first assignee of the contested chose in action for $5,000) would win over the thrift institution (the successive assignee of the same contract right). The rationale is that the depositor lost the contract right when the first assignment was made to the finance company and thus had no right left to convey to the thrift. The giving of public notice, a paramount consideration under article 9, is ignored.

More facts would be necessary to resolve this dispute in a jurisdiction that had adopted the "four horsemen" rule. The first assignee (the finance company) would prevail over the second assignee (the thrift institution) unless one of four events had occurred. If the thrift (the second assignee) had persuaded the depositary institution to pay the full $9,000, or obtained a judgment for $9,000 against the depositary institution, or entered into a novation with the depositary institution, or could have and did take possession of a "symbolic writing" representing the deposit account, the thrift would prevail over the finance company.

The Restatement (Second) of Contracts, which endorses

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299. See U.C.C. §§ 9-312(5)(a), 502, 504(2).
301. See sources cited supra note 300.
302. See E. Farnsworth, supra note 3, § 11.9, at 791-92; Restatement (Second) of Contracts § 342 (1979).
303. See sources cited supra note 302; see, e.g., Judson v. Corcoran, 58 U.S. 612 (1854); In re Gillespie, 15 F. 734, 736 (S.D.N.Y. 1883); Goodyear Tire & Rubber Co. v. Bagg, 292 Mass. 125, 128-29, 197 N.E. 481, 483 (1935); Rabinowitz v. Peo-
the “four horsemen” rule, explains that the reason the first assignee loses when any of the four events occur is that its “equitable interest” is subordinated to the legal rights of the second assignee, a bona fide purchaser for value. In addition, if the first assignee does not demand and receive a symbolic writing from the assignor, it is estopped from defeating a subsequent, more diligent assignee who obtained such a writing. Providing general public notice thus is significant only with the last of the four events.

Finally, if the dispute in example 10 arose in a jurisdiction that applies the English rule, the thrift institution would win for another reason: it was the first assignee to notify the obligor—the depositary institution. This approach is sometimes justified by a “public notice” rationale; once informed by the assignee, the depositary institution could notify subsequent potential creditors and debtors. The depositary institution, however, may not be a reliable source of information.

The common law of pledge, like article 9 and unlike security assignments, emphasizes the giving of notice to subsequent creditors and purchasers. If example 10 had involved a deposit account represented by a “symbolic writing,” the debtor might first have pledged the writing to the finance company and, after temporarily regaining possession, might have repledged the writing to the thrift institution. Assuming both pledgees were

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303. See RESTATEMENT (SECOND) OF CONTRACTS § 342 comment e (1979); see, e.g., Judson v. Corcoran, 58 U.S. 612 (1854).
without notice, the thrift—the creditor in possession—would win even if second in time. 309

If article 9 were expanded as proposed here, these common law rules would be largely displaced. Priority of interests in deposit accounts, as in other personal property, would turn on which claimant had first given public notice, thereby permitting diligent subsequent creditors to adjust their behavior to the increased risk of extending credit.

B. THE PRIORITY BATTLE BETWEEN A CREDITOR WITH AN ARTICLE 9 SECURITY INTEREST IN A DEPOSIT ACCOUNT AS ORIGINAL COLLATERAL AND A CREDITOR WITH AN ARTICLE 9 PROCEEDS SECURITY INTEREST IN THE SAME DEPOSIT ACCOUNT

Courts have difficulty determining when and to what extent a depositary bank can set-off against a deposit account that includes proceeds from property subject to another creditor's article 9 security interest. The Code, however, has rules for resolving conflicts over an item of personal property claimed as encumbered original collateral by one creditor and as encumbered proceeds by another. The following discussion of example 11 shows how application of article 9 rules would simplify the law in this area.

Example 11:
The business depositor has a $10,000 deposit account. The following activity occurs:
Day 1: The account has a balance of $10,000.
Day 2: The depositor grants the depositary bank a security interest in $4,000 of the deposit account as original collateral to secure a $5,000 loan. The security agreement includes an "after-acquired deposit" clause.
Day 3: The depositor grants a security interest to a finance company in "all present and after-acquired inventory and proceeds thereof" to secure a $10,000 loan.
Day 4: The finance company files a properly completed financing statement.
Day 5: The depositary bank files a properly completed financing statement.
Day 6: The depositor deposits $1,000 cash in its account. The cash represents the proceeds of a sale of inventory covered by the finance company's security agreement. The balance in the account is $11,000.
Day 7: The depositor withdraws $6,000 to pay employee expenses, leaving a balance of $5,000.

Ignoring the finance company's interest, on Day 7 the de-

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pository bank has an interest in the account as original collateral in the amount of $5,000. The depositor's subsequent agreement with the finance company on Day 3 does not change the terms of its earlier contract with the depositary bank which covers after-acquired deposits. Similarly, ignoring the depositary bank's interest, the proceeds interest of the finance company is $1,000.310 Because there is only $5,000 in the account, there is a priority battle over $1,000 of the funds.

Article 9 provides that “[c]onflicting security interests rank according to priority in time of filing” and that “a date of filing . . . as to [original] collateral is also a date of filing . . . as to proceeds.”311 A straightforward application of these rules to the facts of example 11 indicates that the finance company will prevail. The finance company filed on Day 4 as to the inventory and can claim that date as to its interest in the proceeds of the inventory as well. By filing on Day 5, the depositary bank lost the race to the public records. The finance company can foreclose against $1,000 of the deposit account and the bank can keep the remaining $4,000.312 This result is sound because had the depositary bank given notice promptly on Day 2, the finance company might not have extended credit on Day 3.

There is one further complication under article 9. Section 9-312(5) (a) states that “[p]riority dates from the time a filing is first made . . . provided that there is no period thereafter when there is neither filing nor perfection.”313 Section 9-306(3) sets forth rules for maintaining a continuously perfected security interest when original collateral (the inventory in example 11)

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310. The 1972 amendments to article 9 make it clear that a security interest in proceeds can be traced into a “commingled deposit account” by using common law principles such as the lowest intermediate balance rule. See, e.g., U.C.C. § 9-306(1). Courts that have considered the issue recently have uniformly taken such an approach. See, e.g., Brown & Williamson Tobacco Corp. v. Nat'l Bank, 504 F.2d 998 (7th Cir. 1974); Universal C.L.T. Credit Corp. v. Farmers Bank, 358 F. Supp. 317 (E.D. Mo. 1973); Rodi Boat Co. v. Provident Tradesmen's Bank & Trust Co., 236 F. Supp. 935 (E.D. Pa.), aff'd, 399 F.2d 259 (3d Cir. 1964); Michigan Nat'l Bank v. Flowers Mobile Homes Sales, Inc., 26 N.C. App. 690, 217 S.E.2d 108 (1975); see also Henning, supra note 179, at 216-24.

Applying the lowest intermediate balance rule to the facts presented in example 11, on Day 6 the finance company had a claim against $1,000 of the $11,000 in the account. The withdrawal by the depositor on the following day is presumed to first come out of funds other than those impressed with the finance company's interest thus leaving the $1,000 claim intact.

311. U.C.C. §§ 9-312(5) (a), 9-312(6).

312. Had the bank filed its financing statement on Day 4, and the finance company filed its financing statement on Day 5, the bank would have been senior to the extent of its $5,000 security interest.

313. U.C.C. § 9-312(5) (a) (emphasis added).
is transformed into proceeds (the deposit account). Under some circumstances, a new financing statement must be filed within ten days after the debtor receives the proceeds.

Article 9 affords potential creditors better notice of an earlier security interest where proceeds are "non-cash" personal property than where the proceeds are deposit accounts, as in example 11. The sponsors of the Code assumed that few creditors would retain security interests in deposit accounts as original collateral. Indeed, there is no procedure under article 9 for creating such an interest. There would thus be little demand for information about whether a deposit account might be the proceeds of some earlier and more senior creditor's interest in other property.

If article 9 were expanded as proposed here, more potential creditors will want to know whether particular deposit accounts are encumbered as proceeds before they rely on those accounts as original collateral. Section 9-306(1) could be amended to provide such notice by deleting "deposit accounts" from the definition of "cash proceeds." As a result, section 9-
306(3)(a) and (c) would govern "deposit accounts" as well as "non-cash proceeds."

This change would affect the secured creditor in example 11. The original collateral in example 11 was inventory. The cash received by the depositor from the sale of inventory was first generation proceeds. When those funds were deposited, the depositor received as second generation proceeds an augmented chose in action against the depositary bank. Under each of the three alternative versions of section 9-401(1), the financing statement covering the original collateral (the inventory) and the ultimate proceeds (the deposit account) would be filed in the same place.\(^{318}\) Under section 9-306 as modified, the first financing statement would be adequate to cover proceeds so long as its description of collateral expressly included deposit accounts.\(^{319}\) A subsequent creditor who contemplated making a loan in reliance on the deposit account as original collateral could uncover the earlier interest in proceeds by searching the state or local file designated for encumbrances on deposit accounts.

In contrast, the outcome of the priority contest in example 11 would be uncertain if the depositary bank asserted its common law right to set-off instead of an article 9 security interest in deposit accounts as original collateral. Courts and commentators disagree about what legal rule to apply, and some of the standards, in turn, raise difficult factual issues.

Assume, for instance, that the bank in example 11 asserted its right to set-off against the entire balance in the account on Day 7. The finance company would claim a senior perfected security interest in the $1,000 of proceeds deposited in the account. The threshold issue would be whether the article 9

\(^{318}\) The proper place to file would be in the office of the secretary of state under alternatives one and two, and in the office of the secretary of state and the county where the debtor has its place of business under alternative three. See U.C.C. § 9-401(1)(b) (first alternative), (c) (second alternative), (c) (third alternative).

\(^{319}\) Because there is a cash interval, deposit accounts would have to be described for the first financing statement to remain effective. See U.C.C. § 9-306(3)(a). If the legislature wanted to place more pressure on secured creditors to police their debtors, it could require that the description of the deposit account in the financing statement covering proceeds include the identity of the depositary institution and the account number. See supra note 116 and accompanying text. Under such a requirement, a secured creditor would have to ascertain whether the depositor in fact deposited proceeds in the designated general deposit account.

In example 11, the ten-day period of temporary automatic perfection of proceeds has not yet elapsed. See U.C.C. § 9-306(3).
priority rules apply to a dispute between a creditor asserting its right to set-off and a creditor holding a perfected proceeds security interest under article 9. Courts that conclude that article 9 priority rules apply give victory to the secured creditor in every case.\textsuperscript{320} Their analysis is straightforward but ultimately unfair to depositary institutions. The proponents of this view reason that article 9 proclaims that “[e]xcept as otherwise provided by this Act a security agreement is effective . . . against creditors.”\textsuperscript{321} The depositary bank, even with an inchoate right to set-off, is only a general creditor\textsuperscript{322} and thus loses to the finance company, which holds a perfected security interest in proceeds.

It is not unfair to require the depositary institution to search the public files for the financing statement of the finance company; that burden would be placed on the depositary institution by the reform proposed here.\textsuperscript{323} It is unfair, however, that the diligent depositary institution cannot obtain the article 9 secured status necessary to prevail because article 9 excludes security interests in deposit accounts as original collateral.\textsuperscript{324}

Other courts and commentators conclude that article 9 priority rules do not govern\textsuperscript{325} and that one of two different common law priority rules should be applied. The majority adopt the “legal” rule: the bank’s right to set-off is superior to the article 9 perfected security interest in proceeds only if the bank had no actual knowledge of the secured party’s proceeds interest in the deposit account and had no reason to inquire whether the deposit account was so encumbered.\textsuperscript{326} The mere


\textsuperscript{321} U.C.C. § 9-201; see Citizens Nat’l Bank, 177 Ind. App. at 555, 360 N.E.2d at 1248; see also National Acceptance Co. of Am. v. Virginia Capital Bank, 498 F. Supp. 1078, 1085 (E.D. Va. 1980).

\textsuperscript{322} See, e.g., Associates Discount Corp., 111 N.J. Super. at 357-59, 286 A.2d at 332.

\textsuperscript{323} See supra Examples 9-11.

\textsuperscript{324} U.C.C. § 9-104(l). The depositary institution’s only other option would be to obtain a common law assignment from its depositor, or if the deposit account is reified, to obtain a common law pledge.

\textsuperscript{325} See, e.g., Commercial Discount Corp. v. Milwaukee W. Bank, 61 Wis. 2d 671, 214 N.W.2d 33 (1974); B. CLARK, supra note 142, ¶ 11.7, at 11-23; Henning, supra note 179, at 238-39, 241; Skilton, supra note 213, at 203-04.

\textsuperscript{326} In National Acceptance Co. of Am. v. Virginia Capital Bank, 498 F. Supp. 1078 (E.D. Va. 1980), a depositor disclosed to the bank’s president at the time deposit accounts were opened that money “would be wired” into the de-
filing of the secured creditor’s financing statement does not constitute notice.327

In a jurisdiction following the legal rule, the dispute in example 11 could not be resolved without more information concerning the depositary bank’s knowledge. For example, if the depositary bank knew that the finance company had been financing the debtor’s inventory for a number of years and that the debtor sent the finance company checks drawn against the deposit account on a weekly basis, further inquiry may have been warranted and the bank might lose.328

The legal rule is unsatisfactory as a priority rule because of the difficulty in ascertaining whether an organization, such as a bank, has knowledge.329 Moreover, this rule favors depositary institutions over all other creditors by excusing such institutions from the obligation to search the article 9 files.

The minority common law priority rule, described as the “equitable” rule, provides that the bank with a right to set-off prevails only if it was without actual knowledge of the competing article 9 interest and it changed its position in reliance on the debtor’s deposit account.330 But what constitutes sufficient detrimental reliance? Presumably, releasing other collateral,
deferred collection, or extending additional credit on the depositor's express promise to maintain a minimum balance would suffice.331

The equitable rule suffers from the same shortcomings as the legal rule. Although the depositary bank is more likely to lose under the equitable rule, notice is still not imputed from an article 9 filing.

By expanding article 9 to cover security interests in deposit accounts, abolishing the common law right to set-off, and making the proposed minor modifications in section 9-306,332 a "pure race" priority rule would displace the nonuniform and inequitable law that presently governs these disputes. Depositary institutions could obtain article 9 security interests in deposit accounts. They would have the corollary responsibility of publicizing their own interests and searching the public files for earlier encumbrances.

C. THE PRIORITY BATTLE BETWEEN A CREDITOR WITH AN ARTICLE 9 SECURITY INTEREST IN A DEPOSIT ACCOUNT AS ORIGINAL COLLATERAL AND ANOTHER CREDITOR WITH A JUDICIAL LIEN AGAINST THE DEPOSIT ACCOUNT

This section explores contests over a deposit account between a general creditor with a judicial lien and a creditor who is an assignee or pledgee under the common law, or who asserts a right to set-off, or who claims an article 9 security interest in deposit accounts as original collateral. In most states, when a creditor brings an in personam action on the debt and obtains a favorable judgment, a judgment lien333 arises against all the debtor's real property that is subject to the jurisdiction of the court but not against the debtor's personalty.334 To obtain an execution lien against personal property, in most states the sheriff, pursuant to a writ of attachment or garnishment issued by the clerk of court, must levy on the property.335


331. See B. Clark, supra note 142, ¶ 11.7, at 11-2; Henning, supra note 179, at 240-42.

332. See supra text accompanying notes 316-19.

333. "A 'judgment lien' is one form of 'judicial liens.' " D. Epstein, Debtor-Creditor Law in a Nutshell 46 n.* (1980).


335. S. Riesenfeld, supra note 334, at 94-96.
Under section 9-301(1)(b), if the secured creditor perfects its security interest before the competing creditor acquires its execution lien through service of the appropriate writ, the secured creditor prevails over the creditor relying on the execution lien.\textsuperscript{336} This rule is yet another example of the Code's preference for pure race priority rules;\textsuperscript{337} the creditor who acts first, either by giving public notice or by enforcing its judgment, wins irrespective of its knowledge of the other creditor's charge against the property.\textsuperscript{338} If the creditor relying on judicial process discovers the secured creditor's financing statement before service of the writ, it can direct the sheriff to execute against unencumbered property of the debtor.

If article 9 were expanded to cover deposit accounts as original collateral, the priority rules discussed above relating to judicial liens could be applied, as illustrated in the following example.

\textit{Example 12:}

The depositor has a $10,000 deposit account. The following activity occurs:

Day 1: The account has a balance of $10,000.

Day 2: The depositor grants the depositary bank a security interest in $3,000 of the deposit account as original collateral to secure a $2,000 loan.

Day 3: A judgment for $10,000 is entered in favor of the finance company in state court. (The finance company had sued the depositor for breach of its obligation to repay $10,000 of advances.)

Day 4: The depositor defaults on the loan extended by the depositary bank.

Day 5: The sheriff, on behalf of the finance company, serves the depositary bank with a writ of garnishment.

Day 6: The depositary bank files a financing statement.

There is a contest between the finance company and the depositary bank over $2,000 of the $10,000 balance in the deposit account. Under section 9-301(3), the finance company becomes a "lien creditor" when it acquires a "lien" on the "property involved."\textsuperscript{339} The finance company would have achieved that status, in most jurisdictions, when the sheriff served the writ on

\begin{footnotesize}
\textsuperscript{336} See U.C.C. § 9-301(1)(b), (3).
\textsuperscript{337} See supra notes 283-309 and accompanying text.
\textsuperscript{338} Under the 1962 version of § 9-301(1)(b), to prevail against a secured creditor, the judicial lienor had to be "without knowledge of the security interest." U.C.C. § 9-301(1)(b) (1962). Deletion of this requirement in 1972 reflects the drafters' desire to limit the role of knowledge in the resolution of priority issues. See 1972 Official Text Showing Changes Made in Former Text of Article 9, Secured Transactions, and of Related Sections and Reasons for Changes, U.C.C. § 9-301.
\textsuperscript{339} U.C.C. § 9-301(3).
\end{footnotesize}
Day 5. On that day, the depositary bank's unperfected security interest would be subordinate to the interest of the finance company under section 9-301(1)(b). The finance company could foreclose on the debtor's entire chose in action against the depositary bank; the bank would have to go to court to collect from the depositor.

In contrast, if the deposit account had been pledged or assigned under the common law, or if the bank had asserted its common law right to set-off, the bank would prevail. Yet only if the deposit account had been pledged would any form of public notice have been given.

If, in order to effect a pledge, an indispensable writing for a reified account had been delivered on Day 2, the depositary bank's interest would be senior to the finance company's later-acquired judicial lien. As under article 9, the lien creditor would have notice through the bank's possession of the indispensable writing.

If the depositary bank had obtained a security assignment rather than a pledge, it would still prevail, even though it gave no general public notice. The depositor's rights would have been partially extinguished by the assignment on Day 2. The finance company's judicial lien, arising on Day 3 at the earliest, could not attach to the portion of the deposit account already alienated.

If the assignee in example 12 were a creditor other than the depositary institution, it would have to notify the depositary in-
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stitution to protect its priority against the competing finance company. If the third-party depositary bank, without notice of the assignment, paid the finance company pursuant to a writ of garnishment, it would be discharged from any obligation to pay the assignee. The outside assignee would be left with only a claim for unjust enrichment against the depositor (the assignor).

The depositary bank in example 12 also would prevail against the finance company if it had asserted its right to set-off. The depositor and the bank were mutually indebted on Day 4 and the bank had an inchoate right to set-off. The bank would not be precluded from subsequently exercising that mature right simply because it received notice of the finance company's interest on Day 5. For example, the depositary bank could have effected set-off on Day 6 by manifesting an intent to set-off and either adjusting its formal records or notifying the depositor. Had set-off been accomplished, the finance company could collect only $8,000 from the depositary bank and would direct the sheriff to execute against the depositor's other property for the balance of the judgment.

Courts in set-off cases, like courts in security assignment cases, reason that the depositary bank prevails under these circumstances because the garnishing finance company has no

346. See E. Farnsworth, supra note 3, § 11.9, at 793 n.28; J. Murray, supra note 150, § 310; Restatement (Second) of Contracts § 341(2) (1979); see also Ornbaun v. First Nat'l Bank, 215 Cal. 72, 76, 8 P.2d 470, 472 (1932).
347. See Restatement (Second) of Contracts § 341 comment c (1979).
348. See supra note 159 and accompanying text.
350. In Baker v. National City Bank, 387 F. Supp. 1137 (N.D. Ohio 1974), aff'd, 511 F.2d 1016 (6th Cir. 1975), the court held that this test of when a set-off is effective was not satisfied where an officer of the bank telephoned the bank's general counsel and advised him of the bank's intention to set-off immediately. Id. at 1149. In addition, a bank memorandum directing that the necessary book entries be entered was insufficient to effect a set-off. Id. at 1150; see also In re Saugus Gen. Hosp., Inc., 689 F.2d 42, 47-48 (1st Cir. 1983).
351. The finance company would not have to obtain a new judgment. Instead, it would seek a second writ of execution (an alias writ). See S. Riesenfeld, supra note 334, at 98 n.1.
greater right to the deposit account than the debtor. On Day 5, the debtor's interest in the deposit account was subordinate to the bank's inchoate right to set-off; accordingly, the finance company's judicial lien is subordinate.

That explanation, however, assumes the answer to the critical question: whether in all circumstances the depositary bank's rights against competing creditors should be identical to the bank's rights against the debtor. Several article 9 provisions give the secured creditor fewer rights against competing creditors than against the debtor. Indeed, the priority rule under section 9-301(1)(b) would be reversed if the Code sponsors had given secured creditors the same rights against lien creditors that they have against debtors. Instead, article 9 requires the secured creditor who seeks victory over a lien creditor to perfect by giving public notice, a matter primarily of concern to competing creditors, but not to the debtor. If the secured party delays, the potential penalty is subordination.

Example 12 demonstrates the futility of extending the coverage of article 9 without abolishing the common law doctrines. If the depositary bank could obtain a senior interest in the contested $2,000 by assignment or set-off, it would lose its incentive to comply with article 9 public notice requirements. Accordingly, sections 9-301(1)(b) and 9-301(3) should be applied to deposit account collateral without modification.

D. THE SECURED PARTY'S RIGHTS IN A DEPOSIT ACCOUNT IN THE EVENT OF INSOLVENCY PROCEEDINGS

Section 9-306(4)(d) governs the disposition of a debtor's deposit account among competing creditors when the account contains commingled funds and insolvency proceedings have been instituted. The section articulates a formula for calculating an outside secured party's interest in proceeds in a de-

352. See, e.g., T & B Gen. Contracting Co., 13 Bankr. at 688; see also supra notes 343-45 and accompanying text.
353. See, e.g., U.C.C. §§ 9-301(1)(b), 9-312(3); see also supra notes 336-40 and accompanying text.
354. U.C.C. § 9-306(4) provides:
(4) In the event of insolvency proceedings instituted by or against a debtor, a secured party with a perfected security interest in proceeds has a perfected security interest only in the following proceeds:
(a) in identifiable non-cash proceeds and in separate deposit accounts containing only proceeds;
(b) in identifiable cash proceeds in the form of money which is neither commingled with other money nor deposited in a deposit account prior to the insolvency proceedings;
(c) in identifiable cash proceeds in the form of checks and the like
posit account and incorporates the common law right to set-off
to define the parameters of the depositary bank's interest.

Generally, section 9-306(4)(d) restricts the outside secured
creditor's claim; presumably, the drafters' goal was to en-
courage better policing of the debtor. The secured creditor's
interest in a commingled deposit account, however, is not simi-
larly restricted if insolvency proceedings have not been com-
enced. Moreover, the depositary bank's interest is not
restricted whether the debtor is solvent or insolvent.

Section 9-306(4)(d) has generated considerable confu-
sion and extensive criticism. As shown by the following
example, the uncertainty could be reduced by substituting arti-
cle 9 for the common law right to set-off. Such reform, however,
only makes the overall unfairness of the rule more apparent.

which are not deposited in a deposit account prior to the insolvency
proceedings; and

(d) in all cash and deposit accounts of the debtor in which pro-
ceeds have been commingled with other funds, but the perfected secur-
ity interest under this paragraph (d) is

(i) subject to any right to set-off, and

(ii) limited to an amount not greater than the amount of any
cash proceeds received by the debtor within ten days before the insti-
tution of the insolvency proceedings less the sum of (I) the payments
to the secured party on account of cash proceeds received by the
debtor during such period and (II) the cash proceeds received by the
debtor during such period to which the secured party is entitled under
paragraphs (a) through (c) of this subsection (4).

Article I defines "insolvency proceedings" as "any assignment for the bene-
fit of creditors or other proceedings intended to liquidate or rehabilitate the es-
tate of the person involved." U.C.C. § 1-201(22). If the debtor files a petition for
bankruptcy under the Bankruptcy Reform Act of 1978, "insolvency proceed-
ings" are "instituted" within the meaning of the Code. See 11 U.S.C. § 301
(1982); U.C.C. § 1-201(23). Section 9-306(4)(d) is not likely, however, to be suc-
cessfully attacked under § 545 of the Bankruptcy Reform Act as an avoidable
n.67; J. WHITE & R. SUMMERS, HANDBOOK OF THE LAW UNDER THE UNIFORM
COMMERCIAL CODE § 24-6, at 1017 (2d ed. 1980). Compare In re Dexter Buick—GMC
Truck Co., 28 U.C.C. REP. SERV. (CALLAGHAN) 243 (Bankr. D.R.I. 1980) (not void-
able under Bankruptcy Act of 1898) with Countryman, Code Security Interests
in Bankruptcy, 4 U.C.C. L.J. 35, 46-49 (1971) (grounds on which the § 9-
306(4)(d) interest is susceptible to attack).

355. See Skilton, The Secured Party's Rights in a Debtor's Bank Account
under Section 9-306(4)(d) of the Uniform Commercial Code, 1978 S. ILL. U.L.J.
60, 64-66, 92-93, infra notes 369-73 and accompanying text. In addition, Code
sponsors believed this section would obviate some tracing problems for the se-
cured party. See infra note 364.

355. Compare In re Gibson Prods., 543 F.2d 652 (9th Cir. 1976), cert. denied,
420 U.S. 946 (1977) with Fitzpatrick v. Philco Fin. Corp., 491 F.2d 1288 (7th Cir.
1974). See generally B. CLARK, supra note 44, ¶ 6.5; J. WHITE & R. SUMMERS,
supra note 354, ¶ 24-6, at 1014-17; Skilton, supra note 355.

357. See, e.g., Murphy & Peitzman, Without a Trace: The Secured Creditor's
Interest in Deposit Account Proceeds, 49 AM. BANKR. L.J. 303 (1975); Skilton,
supra note 355.
Example 13:
The business depositor has a $10,000 deposit account. The following activity occurs:

Day 1: The account has a balance of $10,000.

Day 2: The depositor grants the depositary bank a security interest in $5,000 of the deposit account as original collateral to secure a $5,000 loan. The security agreement includes an "after-acquired deposit" clause.

Day 3: The depositor grants the finance company a security interest in "all present and after-acquired inventory and proceeds thereof" to secure a $10,000 loan.

Day 4: The finance company files a properly completed financing statement.

Day 5: The depositary bank files a properly completed financing statement.

Day 6: The depositor deposits $1,000 in its account, received when inventory covered by the finance company's security agreement was sold. The balance in the account is $11,000.

Day 17: The depositor deposits another $2,000 in its account, received when additional encumbered inventory was sold. The balance in the account is $13,000.

Day 18: The depositor withdraws $8,000 to pay employees, leaving a balance of $5,000.

Day 20: The depositor institutes insolvency proceedings.

The size of the finance company's interest in the deposit account under section 9-306(4)(d) is determined by calculating the statutory minuend and then deducting the statutory subtrahend. The minuend is "the amount of any cash proceeds received by the debtor within ten days before the institution of the insolvency proceedings." In example 13, the minuend would be $2,000. The subtrahend would be zero. Accordingly, the finance company would have a perfected security interest in $2,000 of proceeds in the deposit account.

Section 9-306(4)(d) further provides, however, that this restricted perfected security interest in proceeds is "subject to any right to set-off." Courts uniformly hold that this phrase requires application of the ordinary priority rule governing the contest between an article 9 creditor with a perfected security interest in proceeds and a depositary bank with a right to set-off.

358. See Skilton, supra note 355, at 70-77.
359. On Day 6, more than 10 days before the institution of the insolvency proceedings on Day 20, the debtor received and deposited the $1,000 of proceeds. The debtor received and deposited $2,000 during the ten-day period before insolvency on Day 20. See U.C.C. § 9-306(4)(d)(ii).
360. During the period between Day 10 and Day 20, the debtor did not make any payments to the finance company and the debtor did not receive any cash proceeds that were placed in separate deposit accounts or that were otherwise identifiable and noncommingled. See id.
361. Id. § 9-306(4)(d)(i).
off.\textsuperscript{362} As explained above, however, there is substantial disagreement about what that rule is.\textsuperscript{363}

If article 9 were expanded, section 9-306(4)(d) would have to be amended to reflect the abolition of the depositary bank's right to set-off. One approach, which would minimize the change to this section, would provide that the outside secured creditor's restricted security interest in proceeds is "subject to" any article 9 security interest in the deposit account as original collateral taken by the depositary bank. The phrase "subject to" would refer to other article 9 priority rules. The complexity caused by incorporation of the varying priority rules governing contests between the right to set-off and the security interest in proceeds could thus be avoided.\textsuperscript{364}

Applying this modified version of section 9-306(4)(d) to example 13, the finance company would prevail over the depositary bank as to the $2,000 of proceeds received by the debtor within ten days of insolvency because the financing company filed first.\textsuperscript{365} It is possible that the same result would be reached under the common law, but only if the case were heard in a jurisdiction where the secured party always prevails against a bank asserting its right to set-off,\textsuperscript{366} or if the finance company established under the legal rule that the depositary bank knew, or had reason to know, of the finance company's interest\textsuperscript{367} or established under the equitable rule that the depositary bank did not rely on the deposit account to its detriment.\textsuperscript{368}

Replacing the bank's right to set-off with an article 9 security interest thus would simplify the measurement of outside creditors' security interests in proceeds in commingled bank accounts under section 9-306(4)(d); but this change would not

\begin{itemize}
  \item \textsuperscript{363} See supra notes 320-22 and accompanying text.
  \item \textsuperscript{364} Id. One justification for § 9-306(4)(d) is that it reduces, although it does not eliminate, the need for the outside secured party to trace. See Skilton, supra note 355, at 77-79. The proposal here reintroduces the lowest intermediate balance rule to calculate the interest of the depositary bank. An assumption made throughout this Article is that most credit institutions keep daily, accurate records so that such tracing is possible and not overly burdensome. Id. at 79.
  \item \textsuperscript{365} See U.C.C. § 9-312(5)(a); supra note 288 and accompanying text.
  \item \textsuperscript{366} See supra notes 320-22 and accompanying text.
  \item \textsuperscript{367} See supra notes 326-28 and accompanying text.
  \item \textsuperscript{368} See supra notes 330-31 and accompanying text.
\end{itemize}
make the section any more effectual or equitable. The primary purpose of the section is to encourage the secured party to police the debtor's use of the encumbered proceeds by requiring the debtor to remit proceeds directly, or to keep proceeds in a segregated account, or to remit commingled proceeds every ten days. But the statutory formula has been aptly described as a "rather crude carrot and stick." Moreover, it is difficult to explain why the institution of insolvency proceedings, which might occur regardless of the secured party's failure to police the debtor, triggers the statutory penalty.

Section 9-306(4)(d) also penalizes the secured party, but not the depositary bank, for inadequately supervising the debtor's use of proceeds. Yet both creditors rely on the commingled deposit account as collateral whether the bank's inter-

369. Skilton, supra note 355, at 93. Professor Skilton explains the purposes and shortcomings of § 9-306(4)(d) as follows:

{[S]ection 9-306(4)(d) has the effect of a carrot or a stick. As a carrot, the section induces the secured party to adopt careful policing practices and to insist that the debtor remit within ten days of receipt all cash proceeds deposited in his bank account. As to unremitted cash proceeds so deposited, a special claim is accorded under section 9-306(4)(d). As a stick, section 9-306(4)(d) penalizes lax practices by denying a claim on the debtor's bank account, as to cash proceeds deposited in the debtor's bank account received by the debtor more than ten days prior to the institution of insolvency proceedings.

Section 9-306(4)(d) is however a rather crude carrot and stick, suffering from inconsistency and the potential of injustice. The best policing would be to require the debtor to remit all cash proceeds directly, or at least to require the debtor to deposit them in a separate account. But even a diligent secured party, conscious of the strictures of section 9-306(4)(d), may not be able to control the situation. Such strict policing practices cannot always prevent a debtor from suddenly turning untrustworthy and departing from authorization and depositing cash proceeds in his general bank account rather than a special bank account or remitting them intact to the secured party. The ten days of section 9-306(4)(d) begins to run from the time of receipt and not from the time the secured party learns of the fact. And suppose through extreme diligence or luck the secured party within ten days discovers what has happened and demands payment from the debtor? The cooperation, demanded but not always forthcoming with great dispatch, otherwise the ten days will have run, in case of subsequent insolvency proceedings. And if a more permissive secured party allows the debtor to deposit cash proceeds in his (the debtor's) general bank account, on the condition that all proceeds so deposited be remitted within ten days, a debtor turned suddenly untrustworthy may, in violation of understanding, fail to pay the secured party.

Id.

370. Id. at 93-96. If the finance company's interest were not limited to identifiable cash proceeds received during the ten days immediately preceding bankruptcy, the finance company would have a senior claim to all $3,000 of identifiable proceeds in the deposit account because it was first to file. See U.C.C. § 9-306(4)(d)(ii).

est is described as an inchoate right to set-off or an article 9 security interest. The depositary bank could also police the debtor by requiring, as a condition of its loan, that the debtor maintain a separate loan collateral account or a minimum deposit of funds not encumbered by other creditors.\footnote{See generally \textit{Wallick v. First State Bank}, 532 S.W.2d 520 (Mo. Ct. App. 1976) (bank required debtor to place borrowed funds in a segregated deposit account requiring the signature of both the bank and customer for withdrawals).}

In addition to being excused from any obligation to control the commingled account, under section 9-306(4)(d) the depositary bank often has first claim to the proceeds that a secured creditor who fails to exercise control must relinquish. In example 13, as a result of the imposition of a penalty on the finance company, the depositary bank's recovery out of the deposit account increases from $2,000 to $3,000.\footnote{In example 13, the depositary bank can foreclose against the balance in the account after the senior claim of the finance company is satisfied. Thus, although the debtor deposited $3,000 of proceeds from the sale of inventory in its account, only $2,000 was deposited within 10 days of the institution of insolvency proceedings. Consequently, under § 9-306(4)(d), the finance company would have a senior claim to only $2,000 of proceeds rather than the full $3,000. Concomitantly, the bank's share would increase from $2,000 to $3,000.}

Given the functional equivalence of the right to set-off and the article 9 security interest in a deposit account as original collateral, section 9-306(4)(d) should be revised to treat depositary banks and outside creditors equally, imposing the same statutory penalty on all, however measured. Under such a revision, all general creditors, not solely depositary banks, would benefit from the enforcement of sanctions for failing to police the debtor.

As shown in the previous discussion of the four different basic priority problems, the general propositions of article 9 could be applied beneficially to disputes over deposit account collateral. Replacement of nonuniform and uncertain common law principles with the bright line rules of article 9 would better enable depositary and nondepositary creditors to protect their own interests and discover and rank the interests of their competitors.

\section*{IV. PRIORITY PROBLEMS OUTSIDE THE UNIFORM COMMERCIAL CODE}

Aware of the importance of intermeshing the priority provisions of federal commercial statutes with the nearly uniform
state law created by enactment of the Code,374 Congress included provisions in the Federal Tax Lien Act375 and the Bankruptcy Reform Act376 that recognize the special status of secured creditors who give public notice under article 9.377 This approach permits creditors to assess prospectively their risks in the event of default against one coordinated set of priority rules.378 If a creditor acts promptly to protect its interest in relation to other claimants under article 9, it simultaneously protects its interest in the collateral against the Internal Revenue Service, should a tax lien arise, and against the trustee in bankruptcy, should insolvency proceedings be instituted. Substitution of article 9 for the common law doctrines of set-off, security assignments, and pledge would accomplish even greater uniformity and coherence.

A. THE "NEW" ARTICLE 9 SECURITY INTEREST UNDER THE FEDERAL TAX LIEN ACT

When federal taxes have been assessed, a demand for payment has been made, and an individual fails to pay, a statutory lien in favor of the United States government attaches to all the taxpayer's real and personal property by operation of the Federal Tax Lien Act.379 If a private creditor of the taxpayer obtains a perfected article 9 security interest before the Internal Revenue Service files notice of its tax lien in the proper state office,380 the secured creditor obtains priority with respect to the property described in its security agreement; if the Internal Revenue Service files first, it obtains the senior claim.381 The

374. The Uniform Commercial Code has been enacted by the District of Columbia and by every state but Louisiana. Many states, however, have substantially varied the provisions of article 9. See B. Clark, supra note 44, app. C.
375. See supra note 17.
376. See supra note 18.
378. See Eisenberg, supra note 377, at 968.
Federal Tax Lien Act thus treats the Internal Revenue Service as a “lien creditor,” thereby avoiding frustration of the expectations of private lenders who give public notice under article 9. By substituting an article 9 security interest in deposit accounts as original collateral for the common law right to set-off, contests between private creditors and the federal government over deposit accounts could be resolved under these same provisions without modification, as illustrated by the following example.

Example 14:
The taxpayer has a $10,000 deposit account. The following activity occurs:
Day 1: The account has a balance of $10,000.
Day 2: The taxpayer grants the depositary bank a security interest in $3,000 of the deposit account as original collateral to secure a $2,000 loan.
Day 3: The taxpayer’s failure to pay federal income tax results in a delinquency assessment of $10,000.
Day 4: The taxpayer defaults on the loan extended by the depositary bank.
Day 5: The Internal Revenue Service properly files a notice of tax lien.
Day 6: The depositary bank files a financing statement.

The United States government and the depositary bank have conflicting claims to $2,000 of the $10,000 balance in the deposit account. Under sections 6323(a) and 6323(h) of the Federal Tax Lien Act, the depositary bank would lose because it delayed in giving public notice.

If the bank were asserting its common law right to set-off, the result in example 14 would be the same. Although an inchoate right to set-off prevails over a subsequent private execution lien, it is subordinate to a federal tax lien filed after the

I.R.C. § 6323(a) (1982) provides that the tax lien is “not... valid as against any... holder of a security interest.” To qualify as a “holder of a security interest,” the creditor must take whatever steps are necessary under state law so that its “interest has become protected... against a subsequent judgment lien arising out of an unsecured obligation.” Id. § 6323(h)(1). U.C.C. § 9-301(1)(b) subordinates an unperfected security interest to a subsequent lien creditor, but a perfected security interest prevails.


The bank’s security interest attaches to $3,000, but the taxpayer owes the bank only $2,000 unless the bank makes a claim for collection costs. See U.C.C. § 9-502.

See supra note 381 and accompanying text.

See supra notes 348-50 and accompanying text.
right to set-off matures but before the set-off is actually effected.\textsuperscript{386} The taxpayer-depositor has a property right in the deposit account, defined by state law, to which the federal tax lien attaches.\textsuperscript{387} As a matter of federal law, unless the depository bank effects set-off before the government files, the competing tax lien prevails over the bank's common law right to set-off.\textsuperscript{388}

Although the outcome in example 14 would be the same under either the common law or an expanded article 9, substitution of the latter for the former would have beneficial consequences. Under current law, a diligent depository bank, concerned about its customer's potential tax liability, should ef-
fect set-off as soon as there is "mutual indebtedness." If article 9 displaced set-off, however, the depositary bank, as a secured creditor, could protect its interest against the government merely by filing a financing statement, without foreclosing. The depositary bank could thus inexpensively monitor the balance in the deposit account and give its customer additional time to regain financial health. Premature foreclosure, which might otherwise trigger a chain of events leading to bankruptcy, could be avoided.

Substitution of article 9 for the common law right to set-off would also eliminate factual controversies. Although it is often difficult to ascertain the precise moment when set-off is effected, the hour and date of an article 9 filing is usually marked by a public officer on the financing statement itself.

Finally, the suggested reform would create a more internally logical priority scheme. Under current law, in contests involving a bank's right to set-off the Internal Revenue Service, a public lien creditor, has rights superior to those of a private lien creditor.

B. THE "NEW" ARTICLE 9 SECURITY INTEREST, AS INTEGRATED INTO THE BANKRUPTCY REFORM ACT

The legislative history of the Bankruptcy Reform Act reveals that Congress recognized the functional equivalence

389. In many jurisdictions, the mutual indebtedness requirement is relaxed and the depositary institution is permitted to set-off if it deems itself insecure. In these jurisdictions, the problems discussed in the text would be even more acute. See Murray, supra note 71, at 453-54; Annot., 37 A.L.R.2d 850, 853-56 (1954). Often, the loan agreement or promissory note will provide that the borrower's obligation to repay the balance may be accelerated if the depositary institution is concerned about its borrower's insolvency. See Murray, supra note 71, at 453.

390. See supra notes 380-82 and accompanying text. The Federal Tax Lien Act thus provides an additional incentive for secured creditors to give public notice of their interests.

391. See Lewmore, Monitors and Freeriders in Commercial and Corporate Settings, 92 YALE L.J. 49, 56 (1982) ("A typical commercial bank ... appears to have excellent monitoring ability. It is experienced, enjoys economies of scale, is financially sophisticated, and has ready access to many of the assets and records of the debtor and its business associates.").

392. Set-off is effected when the bank has both manifested a sufficient intent and made an adequate bookkeeping entry or given sufficient notice to its depositor. See supra notes 350-51 and accompanying text.

393. See U.C.C. § 9-403(4).

394. See TeSelle, supra note 70, at 62-66.

under nonbankruptcy law of the common law right of depository institutions to set-off and the rights of creditors holding perfected security interests under article 9. The Act attempts to treat both types of creditors similarly in bankruptcy, ignoring the substantial differences in the prerequisites to achieving each status. But even that limited goal is not fully realized.

The substitution of an article 9 security interest in deposit accounts as original collateral for the common law right to set-off would have significant consequences under the bankruptcy law. A depository institution would no longer be automatically entitled to preferred treatment over general creditors. Instead, like other creditors without statutory or judicial liens, the depository institution would have to establish that it had created a security interest under article 9, that it had satisfied nonbankruptcy public notice requirements prior to the commencement of bankruptcy proceedings, and that its interest in the property of the bankrupt's estate could withstand the full panoply of the bankruptcy trustee's powers of avoidance.

1. Incorporation of the Shortcomings of Nonbankruptcy Law into the Bankruptcy Reform Act

The Bankruptcy Reform Act incorporates by reference the common law requirements for creation of an inchoate right to set-off and the article 9 requirements for the creation of a security interest in traditional collateral. The Act thereby frustrates the bankruptcy goal of treating similar creditors similarly. The special privileges that depository institutions enjoy under nonbankruptcy law, which are unavailable to secured and general creditors, are carried forward into the bankruptcy system. Under nonbankruptcy law, the depository institution, without debtor consent, can set-off against the entire balance in the account at the time of default. This rule enables

400. See supra notes 171-236 and accompanying text.
the depositary institution to obtain a larger bankruptcy recovery.

A creditor's claim, if not fully collateralized, is characterized in bankruptcy as partially "secured" and partially "unsecured."\(^{401}\) The larger the secured portion of the claim, the more the creditor will recover.\(^{402}\) Consider the depositor who, at the time the petition for bankruptcy was filed, owed $10,000 to the depositary bank and had an account with an $8,000 balance. Under nonbankruptcy law, without bargaining with the debtor\(^{403}\) or giving notice to other creditors,\(^{404}\) the bank could set-off against the entire balance of $8,000. In bankruptcy, the bank would hold a secured claim of $8,000 and an unsecured claim of $2,000.\(^{405}\)

If article 9 were substituted for the common law right to set-off, the size of the bank's entitlement would be limited by the terms of the security agreement. Thus, if the security agreement encumbered only $3,000,\(^{406}\) under the Bankruptcy Reform Act the bank would hold a secured claim of $3,000 and an unsecured claim of $7,000. The remaining $5,000 of value in the deposit account would be used to satisfy administrative expenses and would then be distributed on a pro rata basis to the general creditors.\(^{407}\) Moreover, if the bank failed to give public notice of its interest prior to bankruptcy, it would lose its secured status altogether. The bank would then hold only a general claim for $10,000 and the entire $8,000 balance of the deposit account would become the property of the estate, available for distribution on a pro rata basis to all general creditors.\(^{408}\)

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401. Section 506(a) of the Act sets forth the bankruptcy standard for dividing claims. It provides in pertinent part:

[A] claim . . . of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff . . . and is an unsecured claim to the extent that the value of such creditor's interest in the amount so subject to setoff is less than the amount of such . . . claim.


402. The secured claims are satisfied before administrative expenses are paid and before all the claims of the general creditors. See 11 U.S.C. §§ 524, 554, 722, 725 (1982); see generally D. Epstein & J. Landers, supra note 79, at 377.

403. See supra notes 108-236 and accompanying text.

404. See supra notes 237-78 and accompanying text.


406. See supra note 116 and accompanying text.


408. The trustee in bankruptcy may assume the status of a hypothetical lien creditor who extends credit and obtains a judicial lien on the day of the filing of
If article 9, rather than the common law right to set-off, provided the basis for defining the depositary institution's share of the estate, a more equitable and uniform law of nonbankruptcy entitlements would be incorporated in the federal bankruptcy law.409

2. Favored Treatment of Depositary Institutions Under the Fraud Section of the Bankruptcy Reform Act

Not all of the differences in the bankruptcy treatment of deposit accounts, as contrasted with other collateral, are attributable to the shortcomings of nonbankruptcy law.410 For example, the trustee's power to avoid fraudulent transactions involving set-off is more limited under the Bankruptcy Reform Act than the trustee's power to avoid other fraudulent transactions. Under section 548 of the Act, the trustee may avoid the grant of an article 9 security interest if the interest was conveyed with "actual intent to hinder, delay, or defraud" other creditors, or under circumstances warranting a finding of con-

the petition for bankruptcy. See 11 U.S.C. § 544(a)(1) (1982). Like such a lien creditor, the trustee will prevail in a contest with a creditor holding an unperfected article 9 security interest. See U.C.C. § 9-301(1)(b); see generally 4 W. COLLIER, supra note 397, ¶ 544.02. If the trustee exercises this strong arm power in the example set forth in the text, the deposit account would be freed from the encumbrance and would become part of the estate. See 11 U.S.C. §§ 544(a)(1), 550(a) (1982).

Section 544(a) does not give the trustee power to reverse a set-off that has occurred and no cases were located where this power was used to avoid an inchoate right to set-off. The statute permits challenges to "transfer[s] of property of the debtor." Id. §§ 101(41), 544(a). Although the grant of a security interest is such a transfer, set-off is not. Id. Earlier versions of the definition of transfer included set-off, but that language was omitted from the definition that was eventually enacted. See B. CLARK, supra note 44, ¶ 6.4[2][b]; B. CLARK, supra note 142, ¶ 11.10, at 11-30; 4 W. COLLIER, supra note 397, ¶ 553.15, at 553-62 n.15; Freeman, supra note 397, at 491 n.16. Furthermore, even if the creation of an inchoate right to set-off were treated as a transfer, the trustee, as a subsequent lien creditor, would lose to the depositary institution. See supra notes 333-53 and accompanying text.

409. Congress clearly has the constitutional power under the bankruptcy clause to preempt state law and create a uniform bankruptcy law. U.S. CONST. art. I, § 8, cl. 4. Instead, "the bankruptcy system provides . . . a government subsidized debt collection and liquidation mechanism permitting creditors of a common debtor to enforce more effectively their private rights of payment created by credit contracts and nonbankruptcy commercial law." Zubrow, Creditors with Unclean Hands at the Bar of the Bankruptcy Court: A Proposal for Legislative Reform, 58 N.Y.U. L. Rev. 383 (1983); see Eisenberg, supra note 377, at 555-56; Jackson, supra note 377, at 859.

410. This Article discusses only a few of the provisions of the Act which affect deposit account collateral differently than other collateral. Other commentators have written concerning the application of the Act's automatic stay and turnover provisions to deposit account collateral. See, e.g., Weintraub & Resnick, supra note 397.
The transfer of the security interest may occur any time within one year before bankruptcy. If the security interest is avoided, the creditor will be treated as unsecured.

In contrast, section 553(a), which defines the trustee's power to avoid transactions involving set-off, describes a narrow group of transactions that may be avoided and provides that the period of vulnerability to challenge is ninety days rather than one year. Suppose that a depositor, in collusion with its bank and with the intent to defraud other creditors, increased the funds in its deposit account less than one year but no more than ninety days before bankruptcy. Suppose further that the bank effected a set-off against the augmented account during the same period. Under section 553, the trustee could not avoid the set-off and recover the fraudulent buildup of the deposit account for the estate.

Moreover, the trustee could not make use of the more flexible and broad fraud standards of section 548, which would permit avoidance of a fraudulent article 9 floating lien under similar circumstances. Section 548 applies only to a "transfer of an interest of the debtor." When the debtor makes a de-

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411. 11 U.S.C. § 548(a) (1982) provides:

The trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition, if the debtor—

(1) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted; or

(2) (A) received less than a reasonably equivalent value in exchange for such transfer or obligation; and

(B) (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;

(ii) was engaged in business, or was about to engage in business or a transaction, for which any property remaining with the debtor was in unreasonably small capital; or

(iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured.

412. Id.

413. Id. §§ 502(h), 550.

414. Id. § 553(a) (2), (3).

415. When the depositor made the fraudulent deposits, the bank incurred an obligation to repay additional sums to the depositor on demand. Moreover, this "debt . . . was incurred . . . for the purpose of obtaining a right of set-off against the debtor." Id. § 553(a)(3)(C). The debt, however, was not incurred "after 90 days before the date of the filing of the petition." Id. § 553(a)(3)(A).

416. See Freeman, supra note 397, at 497-98.

deposit in the bank account, title to the funds passes to the bank and thus a transfer occurs.\textsuperscript{418} Congress, however, excluded set-off from the definition of transfer\textsuperscript{419} and the language of section 553 strongly implies that it is the only section that curtails the exercise of the right to set-off.\textsuperscript{420} At most, section 548(a) could be read to permit avoidance of a pattern of fraudulent deposits, but not the exercise of the right to set-off against those deposits. Carried to its logical extreme, this construction would permit the trustee to recover fraudulent deposits made during the period between one year before bankruptcy and ninety-one days before bankruptcy only if the bank did not effect set-off during that period. Courts may be reluctant to endorse such a strained reading of section 548,\textsuperscript{421} but even if they did, the bank could still benefit from the fraudulent conduct if the debtor agreed to delay filing the bankruptcy petition until more than ninety days after set-off.

Whether the trustee’s powers are defined exclusively by section 553 or are supplemented by section 548 in the limited manner suggested above, the trustee has less power to attack set-off tainted with fraud than to challenge a fraudulent secured transaction.\textsuperscript{422} Yet depositary institutions, along with other secured creditors, are paid first in bankruptcy based on the view that the right to set-off is the functional equivalent of an article 9 security interest. This anomaly and comparative advantage for depositary institutions would be eliminated if

\footnotesize{\begin{itemize}
\item \textsuperscript{418} See supra text accompanying note 32. Section 101(41) of the Act defines transfer as including “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest.” 11 U.S.C. § 101(41) (1982). The senate report accompanying the senate bill, which included this definition of “transfer,” states that “[a] deposit in a bank account... is a transfer.” S. REP. NO. 989, 95th Cong., 2d Sess. 27, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5813; see also 4 W. COLLIER, supra note 397, ¶ 547.0811[1].

\item \textsuperscript{419} An early version of the definition of transfer stated that “transfer means every mode... of parting with property or with an interest in property, including retention of title as a security interest, and set off.” H.R. 6200, 95th Cong., 1st Sess. § 101(39) (1977) (emphasis added). The version that was enacted did not include the final three words “and set off.” See supra note 418.

\item \textsuperscript{420} Section 553(a) states in pertinent part: “Except as otherwise provided in this section and in sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt... .” 11 U.S.C. § 553(a) (emphasis added).

\item \textsuperscript{421} No case was located where § 548 was applied to either a pattern of deposits in advance of set-off or an exercise of the right to set-off.

\item \textsuperscript{422} The trustee’s subrogational powers under § 544(b) also are limited to “transfers.” Thus, it appears that state fraudulent conveyance law could not be used to challenge a set-off tainted with fraud. See 11 U.S.C. § 544(b) (1982).}
\end{itemize}
set-off were displaced by article 9 under nonbankruptcy law. The broad provisions of section 548 then could be applied to protect uniformly all creditors from any fraudulent creditor claiming the benefits of secured status in bankruptcy.

3. Favored Treatment of Depositary Institutions Under the Preference Sections of the Bankruptcy Reform Act

Section 553(b) of the Bankruptcy Reform Act empowers the trustee in bankruptcy to challenge preferential prebankruptcy set-offs, and section 547 allows the trustee to attack preferential prebankruptcy article 9 floating liens.\(^{423}\) If the trustee had no such power, the debtor could liquidate assets and deposit the funds in an existing or newly created deposit account immediately before bankruptcy and thereby increase the eventual recovery of a favored bank with an inchoate right to set-off. Similarly, the debtor could prefer a creditor with a floating lien by converting resources into property to which the creditor's security interest would automatically attach.\(^ {424}\)

\(^{423}\) 11 U.S.C. § 547(c)(5) (1982) provides in pertinent part:
The trustee may not avoid under this section a transfer—
(5) of a perfected security interest in inventory or a receivable . . . except to the extent that the aggregate of all such transfers to the transferee caused a reduction, as of the date of the filing of the petition and to the prejudice of other creditors holding unsecured claims, of any amount by which the debt secured by such security interest exceeded the value of all security interest for such debt on the later of—
(A) (i) with respect to a transfer to which subsection (b)(4)(A) of this section applies, 90 days before the date of the filing of the petition; or (ii) with respect to a transfer to which subsection (b)(4)(B) of this section applies, one year before the date of the filing of the petition; and
(B) the date on which new value was first given under the security agreement creating such interest . . . .

\(^{424}\) 11 U.S.C. § 553(b) (1982) provides in pertinent part:
(1) . . . [I]f a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—
(A) 90 days before the date of the filing of the petition; and
(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.
(2) In this subsection, "insufficiency" means amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor by the holder of such claim.

The security agreement often contains a clause covering after-acquired property. Under article 9, the creditor's security interest does not attach and become enforceable until the debtor has rights in the collateral. U.C.C. § 9-203(1)(c). When a security interest thus attaches to property acquired by the debtor during the period immediately before bankruptcy, a preferential transfer of the debtor's property to the creditor holding the floating lien occurs. See 11 U.S.C. § 547(b), (e) (1982); see generally Ward & Shulman, In Defense of the
By exercising powers to challenge preferences, the trustee can force both types of benefited creditors to disgorge a portion of such a preferential buildup, whether or not fraud is established and whether the buildup is fortuitous or the result of decisions made during the period immediately before bankruptcy. The trustee’s recovery for the estate is measured by the reduction of the favored creditor’s undercollateralization between two fixed points in time. Under section 553(b), however, the trustee is permitted to challenge only consumated set-offs, not the mere creation of a right to set-off. Thus, unlike an article 9 creditor, if a bank with an inchoate right to set-off does not foreclose prior to the commencement of bankruptcy, it may be able to transform its prebankruptcy improvement of position into an augmented secured claim.

The operation of these bankruptcy preference sections is illustrated by example 15, involving an article 9 floating lien, and example 16, involving the bank’s right to set-off. If article 9 were to displace the common law right to set-off in modern banking transactions, section 547 could be applied to preferences in deposit account collateral in the same manner that it


425. The use of two discrete points in time obviates the need to keep track of daily fluctuations in the value of the collateral and in the outstanding obligation.

Different points in time are used in § 547 and § 553. Under § 547, the period of vulnerability begins either 90 days before bankruptcy or one year before the date of the filing of the petition. 11 U.S.C. § 547(b)(4), (c)(5) (1982). The longer period applies where the benefited creditor is an “insider” with reason to know of the insolvency of the debtor. Id. § 547(b)(4)(B). Section 101(25) defines “insider” broadly to include any creditor with whom the debtor might not deal on an “arms length” basis. Id. § 101(25); see S. REP. No. 989, 95th Cong., 2d Sess. 25, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5487, 5810-11. A preferential transfer to such an individual as early as one year before bankruptcy can be avoided because of the greater opportunity for and likelihood of fraud. For no apparent reason, the preference section for set-off does not extend the period of vulnerability beyond ninety days when the benefited depositary institution is an insider. See 11 U.S.C. § 553(b) (1982). If the nonbankruptcy reform proposed here were enacted, this advantage for insider banks also would be eliminated.

The later point in time is also different for set-off. Under § 547, the time of the filing of the petition governs; under § 553(b), the time that the bank actually effects set-off marks the end point for the calculation. Id. §§ 547(b)(4), (c)(5), 553(b).

426. The following discussion focuses on the preference powers of the trustee. If the trustee could establish that deposits were made during the ninety-day period before bankruptcy for the fraudulent purpose of providing the creditor with a right to set-off, a challenge could be raised under the fraud provision. 11 U.S.C. § 553(a)(3) (1982); see supra notes 411-22 and accompanying text; see generally B. CLARK, supra note 142, ¶ 11.10, at 11-32.
is now applied to article 9 floating liens over inventory or accounts receivable.

**Example 15:**
The debtor receives a loan of $20,000 from its bank and grants the bank an article 9 security interest in “present and after-acquired accounts receivable.” The bank files a financing statement. The following activity occurs:

- **90 days before bankruptcy:** The debtor has accounts receivable worth $10,000 and has not repaid the loan.
- **30 days before bankruptcy:** The debtor has accounts receivable worth $15,000 and has not repaid the loan.
- **15 days before bankruptcy:** The debtor has accounts receivable worth $16,000 and has not repaid the loan.

Bankruptcy petition filed: Everything is the same as fifteen days earlier.

Under section 547(b) and (c)(5), the trustee in bankruptcy could avoid $6,000 of the bank’s security interest in the accounts receivable. This figure represents the amount of the reduction of the bank’s undercollateralization between the ninetieth day before bankruptcy (when the bank was undercollateralized by $10,000) and the day the bankruptcy petition was filed (when the bank was undercollateralized by $4,000). Instead of holding a secured claim in bankruptcy in the amount of $16,000, the bank would be left with a secured claim of only $10,000 and would be a general creditor for the remaining $10,000 owed.\(^{427}\)

**Example 16:**
A depositor with a $10,000 checking account in a bank receives a loan of $20,000 from the same bank.

- **90 days before bankruptcy:** The depositor owes the bank $20,000; the checking account balance is $10,000.
- **30 days before bankruptcy:** The depositor makes a deposit of wholly owned funds increasing the balance in the checking account to $15,000. The loan has not been repaid.
- **15 days before bankruptcy:** The depositor makes another deposit of wholly owned funds increasing the balance in the checking account to $16,000. The loan has not been repaid.

Bankruptcy petition filed: The balance in the checking account is $16,000. The loan has not been repaid.

As in example 15, the bank has improved its position by $6,000 during the period of vulnerability. On the ninetieth day before bankruptcy, the bank was undercollateralized by $10,000 ($20,000 owed, less $10,000 in the checking account) and on the day the bankruptcy petition was filed, it was undercollateralized by $4,000 ($20,000 owed, less $16,000 in the checking ac-

\(^{427}\) See 11 U.S.C. §§ 502(h), 547(b), 550 (1982).
count). Nonetheless, if the bank refrained from effecting set-off in advance of bankruptcy, the trustee may not be able to challenge the bank’s improved position as a preference. Section 553(b) does not appear to apply to an inchoate right to set-off. Accordingly, unlike the similarly situated secured credi-

428. Section 553(b)(1) provides that the trustee can recover from the creditor the “amount . . . offset” to the extent of the reduction of undercollateralization if the “creditor offsets a mutual debt . . . on or within 90 days before the date of the filing of the petition.” *Id.* § 553(b)(1) (emphasis added). Section 553(a) states: “Except as otherwise provided in this section and in sections 362 and 363 . . . , this title does not affect any right of a creditor to offset a mutual debt . . . .” *Id.* § 553(a) (emphasis added).

When read together, these two sentences suggest that the improvement of position test of § 553(b) limits set-offs that have already been effected but not the mere inchoate right to set-off retained by the bank that does not foreclose on the deposit account before bankruptcy commences.

The only detailed explanation of § 553 appears in the House report accompanying House Bill 8200. H.R. Rep. No. 595, 95th Cong., 1st Sess. 183-86, *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 6143-47. That bill, however, differed significantly from the final version of the Act, thus making the House report less probative. The earlier version of the improvement of position test contained in the House bill may have had broader applicability than the test in the final version of the Act. The language of the bill could be read to subject both inchoate and exercised rights to set-off to the improvement of position test. See *H.R. 8200, 95th Cong., 1st Sess.* §§ 101(39), 547(c)(6), 553(a)(4) (1977); *infra* note 436.


Discussion in the context of fraudulent conveyances, the argument could be made that § 547 should be applied where the bank has an inchoate right to set-off. The trustee would argue that § 553 covers only the actual set-off transaction, that deposits are transfers of the debtor’s property, and that the deposits accordingly can be challenged under § 547, independent of the right to set-off. See 11 U.S.C. §§ 101(41), 547(b), (c)(5), 553(b) (1982); *supra* notes 418-21 and accompanying text.

This construction, however, is not supported by the history of the drafting of § 553. Section 553 was enacted to address expressly preferential set-offs resolved under the general preference section of the earlier Bankruptcy Act of 1898. The House bill included set-off in the definition of “transfer” and dealt with the issue of preferential set-offs in both § 547 and § 553. H.R. 8200, 95th Cong., 1st Sess. §§ 101(39), 547(c)(6), 553(a)(4) (1977). But the senate bill and the final act deleted all references to set-off from the definition of transfer and from § 547. See S. 2266, 95th Cong., 1st Sess. §§ 101(40), 547(c)(6) (1977); Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, §§ 101(40), 547(c), 92 Stat. 2549, 2554, 2598 (codified at 11 U.S.C. §§ 101(41), 547(c) (1982)). The cryptic explanation for these changes in the joint explanatory statement of the House and Senate floor managers is that “section 547(c)(6) . . . is treated in a different fashion
tor in example 15, the bank may hold a valid secured claim of $16,000 in bankruptcy.

The bank, like any other secured creditor during bankruptcy, may have difficulty foreclosing on this deposit account collateral. The automatic stay would prohibit postpetition set-off against the deposit account before the close of the case\textsuperscript{429} unless the trustee abandoned the property to the bank\textsuperscript{430} or the bank persuaded the court to grant relief from the stay.\textsuperscript{431} In a reorganization proceeding, the automatic stay could thus mean a substantial delay before the bank could foreclose; in a liquidation case, the postponement would be shorter. Nevertheless, the bank ultimately would receive more favorable treatment than general creditors to the extent of its $16,000 secured claim under either chapter 7 or chapter 11.\textsuperscript{432} The article 9 creditor in example 15 is in an identical position with respect to its reduced secured claim of $10,000 but would lose its secured status as to the $6,000 that was avoided under section 547.\textsuperscript{433}

The legislative history of the Bankruptcy Reform Act indicates that Congress decided to allow banks to retain their inchoate right to set-off after bankruptcy to encourage them to refrain from effecting set-offs immediately before bankruptcy.\textsuperscript{434} Such restraint would permit depositors to pursue in-

\textsuperscript{429} In a Chapter 7 liquidation proceeding, it is less likely that the deposit account will be used, so the trustee may agree to the postpetition set-off or the bankruptcy court may grant an order permitting such set-off. See id. § 363; Freeman, supra note 397, at 522.

\textsuperscript{430} Under Chapter 11, the bank should be able to obtain, absent consent to a lesser amount, the amount of the right to set-off ($16,000) in "cash," or in "deferred cash payments totaling at least the allowed amount of such claim," or "the indubitable equivalent" of such claim. 11 U.S.C. § 1129(b)(2)(A)(i), (iii) (1982); see Freeman, supra note 397, at 519-22.

\textsuperscript{431} If the trustee avoids the security interest, the secured creditor becomes a holder of an unsecured claim. See 11 U.S.C. § 506(a) (1982). The discharge following the bankruptcy distribution extinguishes any unpaid portion of the debt. See id. § 524(a).

formal measures short of bankruptcy, such as composition and extension agreements, to improve their finances. If the Act went no further, a bank with an inchoate right to set-off would be treated similarly to a creditor holding a perfected article 9 floating lien that was not subject to attack by the trustee as a preference.\textsuperscript{435} Section 553, however, when read literally, per-

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435. The Act treats banks that effect set-off before bankruptcy the same as article 9 creditors that foreclose on floating liens. In examples 15 and 16, each creditor would end up with approximately $10,000 in cash and an unsecured claim for $10,000. In other words, each creditor would be returned to the position it occupied at the commencement of the period of vulnerability.

Assume in example 16 that the bank actually effected set-off on the fourteenth day before bankruptcy, thereby triggering application of § 553(b). The bank would alter its records to show that the depositor owed only $4,000 and that the balance in the depositor’s checking account was zero. Following set-off, the bank would be undercollateralized by $4,000. After the filing of the bankruptcy petition, the trustee in bankruptcy would be able to recover $6,000, the reduction of undercollateralization from the ninetieth day before bankruptcy (when the bank was undercollateralized by $10,000) to the date of the actual set-off (when the bank was undercollateralized by $4,000). See 11 U.S.C. §§ 502(h), 553(b) (1) (1982); see generally Freeman, supra note 397, at 499 n.34. The bank would keep $10,000 and it would be an unsecured creditor in bankruptcy for $10,000 (the $4,000 still owed by the depositor plus a $6,000 general claim to compensate for the trustee’s recapture of the $6,000 preference).

The article 9 creditor in example 15 would end up in an identical position if it foreclosed on the fourteenth day before bankruptcy, reposessed accounts receivable with a fair market value of $16,000, and resold them at the market price. Applying the formula of § 547(c) (5), the reduction of undercollateralization would be $6,000. The trustee would recover that amount from the article 9 creditor—the cash from the sale of the reposessed accounts represents its prebankruptcy improvement in position.

The repossession of accounts receivable on the fourteenth day before bankruptcy could be treated analytically as a separate transfer of the debtor’s property which the trustee could avoid as a preference unless the transfer is saved by an exception in § 547. Each of the elements of § 547(b) is satisfied and it does not matter if the transfer is involuntary. See 11 U.S.C. §§ 101(41), 547(b) (1982).

Section 547 excepts “contemporaneous exchange[s].” Id. § 547(c)(1). Here, the creditor gave value in exchange for the transfer of the accounts receivable by the release of its security interest. Such a release, however, will qualify as “new value” under § 547(c)(1) only if the security interest was not itself gained in an earlier transaction that the trustee could avoid. See id. § 547(a) (2). On the facts presented, the creditor gave “new value” only to the extent of the release of a security interest of $10,000; its security interest in the other $6,000 was gained by an independently voidable preferential buildup.

The outcome would be the same in examples 15 and 16 if set-off or repossession occurred on the twenty-ninth day before bankruptcy. In example 16, under § 553(b), the trustee could recover only $5,000 from the bank—the reduction of undercollateralization during the first sixty days of the period of vulnerability. The bank would keep $10,000 and would be a general creditor in bankruptcy for the remaining $10,000 ($5,000 owed by the depositor after set-off and $5,000 to replace the funds recaptured by the trustee).

Similarly, if the creditor in example 15 reposessed and resold $15,000 of accounts receivables on the twenty-ninth day before bankruptcy, under § 547(c) (5), the reduction of undercollateralization during the entire preference
mits the bank to retain an inchoate right to set-off even if a prebankruptcy preferential buildup has augmented the deposit account balance.\textsuperscript{436} It is by no means clear that a bank thus allowed to effect postpetition set-off will forebear foreclosing against a debtor in dire financial straits.\textsuperscript{437} In any case, there is no basis for providing a greater inducement to depositary insti-

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\item \textsuperscript{436} The original bill introduced in the House is less susceptible to a construction that would allow the bank to retain an inchoate right to set-off against a preferentially augmented deposit account. The bill provided that “this title does not affect any right of a creditor to offset after the commencement of the case, except to the extent that” there was a preferential buildup during the designated prebankruptcy period. H.R. 8200, 95th Cong., 1st Sess. § 553(a)(4) (1977) (emphasis added). In other words, unlike the final version of § 553, the House bill apparently limited the postpetition right to set-off by the improvement in position test. In contrast, the Senate bill, like the final version of the Act, applies the improvement in position test only where a creditor “offsets a mutual debt on or within 90 days before the date of the filing of the petition.” S. 2265, 95th Cong., 2d Sess. § 553(b) (1978); Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 553(b), 92 Stat. 2549, 2603 (codified at 11 U.S.C. § 553(b) (1982)). Neither the original Senate report accompanying the Senate bill nor the joint explanatory statement of the floor managers prior to their agreement on a compromise bill contains an explanation of the change. See S. REP. No. 989, 95th Cong., 2d Sess. 91-92, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5787, 5877-78; 124 CONG. REC. 33,400 (1978).
\item \textsuperscript{437} Representatives of a large banking association testified before Congress that under the prior Act, in most cases banks effected set-off when they learned that the borrower-depositor had filed a petition for bankruptcy. \textit{Hearings on H.R. 31 & 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong., 2d Sess. 2505-06 (1976).} They claimed that banks engage in “cash management” when they uncover the debtor company's financial problems before bankruptcy. Under such circumstances, the debtor rarely ends up with “much money” in its bank account when the bankruptcy petition is filed. \textit{Id. at 2510.} The bankers did not elaborate on how the money in the deposit account is ordinarily used during the prepetition “work-out” period nor did they explain what steps, if any, banks take to protect their interests. \textit{Id. at 2484-511.} The bankers testified that banks would work “assiduously” with debtors in an “out-of-court environment” instead of “hitting and running and quickly leaving the environment” if they knew they would be “adequately protected at the end of the road.” \textit{Id. at 2486.} But they also explained that many bankers think that “in a failing corporation, it represents an unrealistic waste of assets to have them squandered in the final gasp of an effort to rekindle an ongoing business when our experience indicates, regrettable as it is, that in bankruptcies particularly of your smaller and medium-sized companies, that most of these companies have a tough time reorganizing.” \textit{Id. at 2508.}
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tutions than that afforded creditors holding perfected article 9 security interests. If the nonbankruptcy law were altered as proposed in this Article, section 547(c)(5) could be amended to add "deposit accounts" to its coverage and a single section of the Act would thus govern all preference challenges.

This Article does not exhaustively examine the ramifications of the recommended alteration of nonbankruptcy law on the bankruptcy distribution.\textsuperscript{438} The exemption sections of the Act also deserve careful consideration.\textsuperscript{439} For example, Congress might exempt the individual debtor's interest, up to a specified dollar figure, in any deposit account held primarily for the personal, family, or household use of the debtor or the debtor's dependents. Similarly, Congress might give the debtor the power to avoid an article 9 security interest in, or a judicial lien against, such a personal deposit account to the extent that the creditor's interest would impair an exemption to which the debtor would otherwise be entitled.\textsuperscript{440}

In sum, the proposed improvements in the nonbankruptcy law should also benefit the bankruptcy system. If the debtor has greater control over the deposit account collateral, if all creditors have a fair chance to compete for the lending opportunity, and if information can be more readily obtained concerning whether the debtor is overextended, the number of bankruptcies might be reduced. Should a bankruptcy petition be filed, depositary institutions would be treated the same as other creditors with rights in the bankrupt's personal property. The law would thus become more simple and equitable.

V. DEFAULT

This Article has proposed that deposit accounts be brought within the framework of article 9 and that the common law of security assignments, pledge, and set-off be displaced. This proposal raises the question whether the default provisions of article 9, which have been described elsewhere as creating a

\textsuperscript{438} For example, the substitution of article 9 for the law of security assignments, which would alter the outcome of a nonbankruptcy contest with a lien creditor, would affect the timing of transfers under § 547(e)(1)(B). See 11 U.S.C. § 547(e)(1)(B) (1982); supra notes 339-40, 343-45, and accompanying text. Some transactions that would not constitute preferences if controlled by the common law would be voidable if subject to article 9. A creditor's failure to give public notice under article 9, not a requirement under the common law, could postpone the transfer, thereby making it "on account of an antecedent debt." See 11 U.S.C. §§ 547(b)(2), (e)(1)(B), (e)(2) (1982).

\textsuperscript{439} See id. § 522.

\textsuperscript{440} See id. § 522(f).
procreditor "deficiency judgment machine," should govern the secured creditor's rights against the defaulting debtor's deposit account.441 The Code encourages nonjudicial foreclosure and validates deficiency judgments.442 Default, which is often broadly defined in the security agreement, triggers article 9 remedies,443 and the Code does not effectively limit insecurity and acceleration clauses.444 Moreover, the secured creditor's remedies against the debtor are cumulative.445 In contrast, the debtor has only a limited right of redemption446 and some potentially powerful but ambiguous statutory remedies447 which

441. See B. CLARK, supra note 44, ¶ 12.5[1].
442. See U.C.C. §§ 9-502, 9-503, 9-504(2).
443. Id. § 9-501(1).
444. U.C.C. § 1-208 limits enforcement of an acceleration clause to circumstances where the secured party "in good faith believes that the prospect of payment or performance is impaired." The debtor, however, has the difficult burden of establishing the absence of good faith. See id. §§ 1-201(19), 1-208; see also B. CLARK, supra note 44, ¶¶ 4.2[1], 12.5[1].

The Uniform Consumer Credit Code has a more objective definition of "consumer default." It provides in pertinent part: "An agreement . . . with respect to default . . . is enforceable only to the extent that: (1) the consumer fails to make a payment . . . or (2) the prospect of payment . . . is significantly impaired . . . ." U.C.C.C. § 5.109 (1974).

446. To redeem collateral under the Code, the debtor, whether a commercial entity or a consumer, must tender "fulfillment of all obligations secured by the collateral" as well as the secured creditor's reasonable expenses in "retaking, holding and preparing the collateral for disposition, in arranging for the sale, and to the extent provided in the agreement and not prohibited by law, his reasonable attorneys' fees and legal expenses." U.C.C.C. § 9-506 (emphasis added). In other words, the debtor must pay the entire balance owed on the obligation and expenses, not just the missed installments.

In contrast, under the Bankruptcy Reform Act, consumer bankrupts, under specified circumstances, can redeem by tendering the amount of the creditor's "allowed secured claim," which is, in effect, the value of the encumbered property. See 11 U.S.C. §§ 506(a), 722 (1982). Under the Uniform Commercial Credit Code, the debtor only has to repay the "amount of all unpaid sums due at the time of the tender, without acceleration, plus any unpaid delinquency or deferral charges." U.C.C.C. §§ 5.110, 5.111 (1974).

447. U.C.C. § 9-507(1) permits recovery of "any loss caused by failure to comply with the provisions of this Part." Damages are awarded on either a contract or tort theory. 2 G. GILMORE, supra note 19, § 44.9.2, at 1256. Some courts have awarded punitive damages. See, e.g., Davidson v. First Bank & Trust Co., 559 P.2d 1228, 1231 (Okla. 1976). Where consumer goods are encumbered, a minimum civil penalty can be imposed. U.C.C. § 9-507(1); see, e.g., Conti Causeway Ford v. Jarossy, 114 N.J. Super. 382, 386-87, 276 A.2d 402, 404-05 (1972).

Some courts have held that the secured party forfeits its right to sue for a deficiency if it fails to comply with article 9. See B. CLARK, supra note 44, ¶ 4.12[4] (citing cases). Some states have enacted consumer credit protection statutes requiring an election of remedies. See infra notes 480-82 and accompanying text. It is not clear whether the three monetary sanctions provided in the
are effective on a showing of a violation of the rules of this "loosely organized, informal, anything-goes ... foreclosure pattern."448

A state legislature that is concerned that the default provisions of article 9 are too creditor oriented, particularly where the debtor is a small commercial entity or a consumer, might choose to treat deposit account financing similarly to true consignments and only partially integrate these transactions into the Code. Article 9 rules concerning creation of an interest in deposit account collateral, public notice, and priorities could be applied and other law could define the consequences of default.449

The common law remedies for a depositary institution, however, are also expansive.450 Like a secured creditor, the bank with a right to set-off may extinguish cross-demands extrajudicially and then bring an in personam action for the deficiency. The bank may define default broadly to ensure early satisfaction of the mutual indebtedness requirement for set-off.451 Set-off is only one of numerous cumulative remedies; a depositary institution may also set-off against the debtor's balance, enforce an article 9 security interest or other lien against the debtor's tangible property, and bring an action in court against the debtor.452

Code are cumulative or whether the debtor must make an election. B. CLARK, supra note 44, ¶ 4.12[5].

448. 2 G. GILMORE, supra note 19, § 43.1, at 1183.

449. See U.C.C. §§ 2-326, 9-114.

450. The discussion in the text focuses on the common law right to set-off, but pledgees and assignees also have expansive remedies. See, e.g., RESTATEMENT OF SECURITY § 48 (1941).

Professor Gilmore notes that the movement under the common law during the nineteenth century from different independent security devices to a unified concept of security in personal property is "nowhere ... more apparent and more thoroughgoing than in the area of rights after default." 2 G. GILMORE, supra note 19, § 43.1, at 1181. Moreover, the doctrine that a creditor must elect between an action on the debt and foreclosure against the collateral was never applied in connection with pledges or security assignments of intangibles. Id. § 43.6, at 1224.

451. See, e.g., Valley Nat'l Bank v. Hasper, 432 P.2d 924 (Ariz. Ct. App. 1967) (event of default was to remove other collateral from state); Barsco, Inc. v. H.W.W., Inc., 346 So.2d 134 (Fla. Dist. Ct. App. 1977) (event of default under security agreement triggering right to set-off was failure to insure other tangible collateral); see generally B. CLARK, supra note 44, ¶ 11.5[1], [3]; supra notes 159-62 and accompanying text.

This Article suggests a number of changes in the article 9 default sections which are intended to afford greater protection to the debtor in default under the Code than under the common law of set-off. Providing remedies for default within the framework of article 9 will ensure that nondepositary creditors have the same remedies as depositary institutions and that the law is more uniform from state to state. From a broader perspective, should the Code's default provisions be revised, whether through amendment or enactment of separate consumer credit protection statutes, credit transactions secured by deposit accounts, as an integral part of article 9, could share in the reform.

A. Remedies in Consumer and Commercial Transactions Secured by Deposit Accounts

Section 9-502, which provides for enforcement of a security interest in general intangibles, allows the creditor with an article 9 security interest in a deposit account as original collateral to collect extrajudicially simply by asking the account debtor to pay the creditor directly. A depositary institution that has a California statute requires a depositary institution to first foreclose against real estate security before exercising a right to set-off against deposit accounts. California, however, has no similar statute with respect to personal property. See Cal. Civ. Proc. Code § 726 (West 1980 & Supp. 1984); Cal. Com. Code § 9501(1) (West 1984 & Supp. 1984); see generally supra note 9.

453. Substitution of article 9 for the common law right to set-off would provide some additional protection to a surety. Under U.C.C. § 3-606(1)(b), a secured creditor who permits the principal debtor to "impair" the "collateral" discharges a surety. The majority of courts, however, have held that a bank does not risk discharging a surety by failing to effect set-off once mutual indebtedness occurs. See, e.g., Bank of Am. Nat'l Trust & Sav. Ass'n v. Liberty Nat'l Bank & Trust Co., 116 F. Supp. 233, 246 n.57 (W.D. Okla. 1953), aff'd, 218 F.2d 831 (10th Cir. 1955); Bank of Cal. v. Starrett, 110 Wash. 231, 236, 188 P. 410, 412 (1920). See generally 5A McW, supra note 32, ch. 9, § 150. If the depositary institution were treated as an article 9 secured creditor, and deposit accounts were treated no differently than other forms of personal property, the depositary institution would have to foreclose in order to avoid releasing the surety under § 3-606(1)(b), absent a contrary agreement with the surety. See B. Clark, supra note 142, § 11.13.


Specifically, U.C.C. § 9-502 provides:

(1) When so agreed and in any event on default the secured party is entitled to notify account debtor or the obligor on an instrument to
made a loan to a customer, and consequently is both a secured party and an account debtor, would pay itself by making the appropriate bookkeeping entries.455 A secured party that is an outside creditor would ask the depositary institution (the account debtor) to pay it, rather than the depositor (the principal debtor), out of the deposit account.456

When applied in this manner, section 9-502 affords the principal debtor less protection than other article 9 self-help foreclosure provisions. None of the default provisions require the secured creditor to notify the debtor in advance of repossession.457 Otherwise, the debtor might dissipate the collateral—a matter of particular concern if the collateral is a liquid deposit account. Under the other Code sections, however, the secured party must give notice after repossession and before final disposition of the property.458 For example, the debtor ordinarily must receive written notice before a sale by a secured party of repossessed tangible collateral.459 If the secured party retains such collateral in satisfaction of the obligation, a written proposal must be given to the debtor, who then may object.460

make payment to him whether or not the assignor was theretofore making collections on the collateral, and also to take control of any proceeds to which he is entitled under Section 9-306.

(2) A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who undertakes to collect from the account debtors or obligors must proceed in a commercially reasonable manner and may deduct his reasonable expenses of realization from the collections. If the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency.

U.C.C. § 9-105 includes in the definition of an “account debtor” a person who is obligated “on [a] . . . general intangible.” 455. See supra note 350 and accompanying text.

456. Stated more precisely, instead of performing its obligation under the deposit agreement by making payment to the depositor, the depositary bank would discharge its obligation by paying the secured party.


A New York statute requires notice to the depositor “prior to, or on the same business day of [set-off],” but failure to give notice does not defeat the set-off. See N.Y. BANKING LAW § 9-g(2), (3) (McKinney Supp. 1983).

458. See U.C.C. §§ 9-504(2), 9-505(2).

459. Such notice need not be given if the “collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market.” Id., § 9-504(3).

460. See id., § 9-505(2).
Such post-repossession notice allows the debtor to redeem the collateral before final disposition.\textsuperscript{461} The debtor may decide to repurchase the repossessed property from the creditor\textsuperscript{462} because the value of the goods to the debtor exceeds their fair market value, or because the debtor fears that the creditor will not realize a fair return on resale, or for some other reason.\textsuperscript{463} These considerations may be less important when the collateral is a deposit account. In such instances, there would be little dispute over value. Nevertheless, a debtor faced with substantial penalties under the deposit agreement for reduction of the balance below a minimum level, or with an unfavorable change in interest rates, may find it more economical to borrow money elsewhere and redeem the deposit account.

Post-repossession notice would be useful for other reasons as well. Such notice may be the first communication to the debtor of the creditor's decision to seek relief.\textsuperscript{464} If there is a dispute about whether default has occurred, or if an informal repayment arrangement is feasible, early notice may be invaluable. If the debtor is a consumer, or if the amount involved is insubstantial, informal negotiation may be the only opportunity for the debtor's views to be presented.\textsuperscript{465} Early notice also would enable the debtor to stop writing checks on a repossessed demand account. As under other article 9 sections, notice in any reasonable written form, and within a reasonable period following repossession, would suffice without placing an onerous burden on creditors.\textsuperscript{466}

\textsuperscript{461} See id. § 9-506.
\textsuperscript{462} See id. The debtor must tender "fulfillment of all obligations secured by the collateral" as well as the secured party's expenses. Id.
\textsuperscript{463} "[E]very aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable." Id. The debtor, however, may not want to litigate this issue. Courts rarely invalidate a sale by a secured party on the sole ground that the resale price was too low; an inadequate price is only one indicia of commercial unreasonableness. See B. CLARK, supra note 44, ¶ 4.8[8].
\textsuperscript{464} Secured creditors frequently overlook one or two late payments before exercising their right to repossess. If there is a pattern of accepting late payments, the secured creditor may have difficulty establishing that a default has occurred that justifies remedial action. See B. CLARK, supra note 44, ¶ 12.5[1][b].
\textsuperscript{465} Litigation may be avoided for several reasons: it is time consuming and expensive; the debtor may not recognize the violation of rights; or the creditor may not initiate a lawsuit because it has already recovered a substantial part of the obligation through the use of informal collection methods and self-help remedies.
\textsuperscript{466} See, e.g., U.C.C. § 9-505(2). At a minimum, such notice would identify the creditor, the loan, the deposit account foreclosed on, and the secured creditor's view of the amount of the obligation outstanding. Commercial debtors, as
The section 9-502 procedure, unless modified, also may cause problems for the depositor institution when it acts solely as an account debtor and not also as a secured party. Under such circumstances, the depositor bank will want proof that the claim of the secured party, an outside creditor, is bona fide before making payment. Wrongful payment could result in claims by the bank's customer, the principal debtor, that the bank made an unauthorized charge against the customer's account or wrongfully dishonored checks drawn by the customer.467

The Code could be supplemented to give an account debtor, notified under section 9-502, protections similar to those explicitly afforded an account debtor when the principal debtor assigns its contract.468 For example, the secured party could be required to deliver a copy of the security agreement (revealing the sum encumbered) and an affidavit swearing that a default has occurred and stating the balance outstanding. If the secured party failed to furnish this proof, the account debtor could refuse to pay.469

The debtor could limit the secured party's self-help remedies by including protective provisions in the security agreement.470 The depositary bank would discover such provisions when the security agreement was delivered as part of the section 9-502 notice. Alternatively, the principal debtor, when opening the account, could bargain with the depositary institution for a provision in the deposit agreement forbidding payment of outside creditors without prior approval by the debtor. A potential subsequent creditor, if diligent, would learn of the loss of the section 9-502 remedy when it read the deposit agreement and could adjust the terms offered the debtor. Even with-

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467. See U.C.C. §§ 4-401(1), 4-402.
468. See id. § 9-318(3). The account debtor faces the same risk of double liability if it pays the wrong entity following receipt of a purportedly valid § 9-502 notice as it does if it pays after learning that the principal debtor assigned the contract. At least one court has read the notice requirements of § 9-318(3) into § 9-502. See Surety Sav. & Loan Co. v. Kanzig, 53 Ohio St. 2d 108, 113, 373 N.E. 2d 602, 605-06 (1978). U.C.C. § 9-318(3) requires that the account debtor receive notice that "the amount due or to become due has been assigned and that payment is to be made to the assignee." In addition, the notice must "reasonably identify the rights assigned." Id. The account debtor may request "reasonable proof . . . that the assignment has been made." Id.
469. Cf. U.C.C. § 9-318(3) (account debtor may pay assignor until account debtor receives reasonable proof of assignment).
470. Such protective clauses are enforceable under the current Code. See id. § 9-501(1)-(3).
out a self-help remedy, a perfected security interest in the deposit account would be of value. For example, if the secured creditor obtained a judicial lien, its priority date would relate back to the time when the security interest was perfected by filing.471

B. SPECIAL PROTECTION FOR THE CONSUMER DEBTOR IN DEFAULT

The sponsors of article 9, to ensure widespread enactment of the proposed Code, did not address many of the controversial issues raised in secured transactions involving consumer debtors.472 The civil penalty provision,473 one of the few article 9 consumer protection sections, easily could be broadened to cover creditor misbehavior in foreclosing against consumer deposit accounts.474 A debtor that established that a secured party had enforced its security interest in violation of article 9 could recover "the credit service charge plus ten percent of the principal amount of the debt."475 The debtor would not need to establish actual loss.476

Non-Code law regulating consumer credit, including statutes and cases that curb the power of creditors when debtors default, supplements and supersedes article 9 provisions.477 If article 9 were expanded to cover deposit account collateral, this non-Code law also could be extended to protect consumer debtors who hypothecate their deposit accounts.

Article 9 has been criticized for allowing creditors to both repossess encumbered property and sue for deficiency judgments. Consumer advocates argue that creditors, unless required to elect one remedy, are likely to resell repossessed collateral below fair market value and to add unwarranted collection costs, as well as attorneys' fees, to their claims in subsequent deficiency actions.478 Where the collateral is a consumer deposit account, few valuation disputes will occur. Excessive collection costs and attorneys' fees, however, may be added if

471. Id. § 9-501(5).
472. See 1 G. Gilmore, supra note 19, § 9.1, at 293-94.
473. U.C.C. § 9-507(1).
474. See supra note 110 and accompanying text (possible definitions of consumer deposit account); see also Cal. Fin. Code § 864(a)(1), (2) (West Supp. 1984); infra note 487.
475. U.C.C. § 9-507(1).
476. Id.; see 2 G. Gilmore, supra note 19, § 44.9.3.
the security agreement so provides.\textsuperscript{479}

In response to these concerns, states have enacted a variety of statutes restricting secured creditors' remedies in consumer transactions. Some states require the creditor to elect a remedy, an approach that could be used to protect consumer deposit accounts. In Massachusetts, for example, if the transaction were secured by a consumer deposit account and if the outstanding loan balance were less than $1,000, the creditor could be required to choose between self-help foreclosure or an action on the debt.\textsuperscript{480} A Wisconsin creditor seeking self-help repossession of a consumer deposit account would have to obtain the consent of the debtor.\textsuperscript{481} Another alternative would be to ban self-help foreclosure if it would reduce the balance in a consumer deposit account below a statutorily prescribed minimum, for example, $1,000.\textsuperscript{482}

Many states limit the enforceability of attorneys' fees clauses in security agreements signed by consumers, thereby superseding the Code.\textsuperscript{483} The same rules could apply where consumer deposit accounts were given as collateral. Wisconsin, for example, prohibits such provisions altogether.\textsuperscript{484} The Uniform Consumer Credit Code prohibits all attorneys' fees clauses where the loan is less than $1,000. For loans of $1,000 or more, attorneys' fees are either banned or are allowed up to a maximum of fifteen percent of the unpaid debt.\textsuperscript{485}

California's innovative legislation protecting consumers from the common law right to set-off suggests yet another approach to limiting self-help enforcement against consumer deposit accounts.\textsuperscript{486} A state could require the depository

\textsuperscript{479} Article 9 explicitly sanctions such charges. See U.C.C. §§ 9-201, 9-504(1)(a).


\textsuperscript{482} See infra note 486.

\textsuperscript{483} See U.C.C. §§ 9-201, 9-504(1)(a).


\textsuperscript{485} U.C.C.C. § 2.507 (alternatives A, B) (1974).

\textsuperscript{486} See Cal. Fin. Code § 864 (West Supp. 1984). As mentioned above, California is one of the few states that provides for the creation of an article 9 security interest in deposit accounts. See supra note 22. A bank may rely on such a security interest or on its common law right to set-off. Where the deposit account is other than a checking account and the bank retains a security interest, it need not comply with the consumer protection statute set out below.

Cal. Fin. Code § 864 (West Supp. 1984) provides in pertinent part:

(a) For the purposes of this section:

(1) "Customer" means one or more natural persons.

(2) "Debt" means an . . . obligation . . . arising from an extension of
institution to immediately and temporarily freeze the consumer deposit account for twenty days after receipt of a request to

credit to a natural person primarily for personal, family, or household purposes, and does not mean a charge for bank services or a debit for uncompelled funds or for an overdraft of an account imposed by a bank on a deposit account.

(b) A bank is limited in exercising any setoff for a debt claimed to be owed to the bank by a customer in that a setoff shall not result in an aggregate balance of less than one thousand dollars ($1,000) as shown on the records of the bank for all demand deposit accounts maintained by a customer with the bank or any branch thereof.

(c) Not later than the day following the exercise of any setoff with respect to a deposit account . . . the bank shall deliver to each customer . . . a written notice . . . containing the following:

(1) A statement that the bank has setoff a debt . . . against the customer's deposit account, identifying the account, and giving the respective balances before and after the setoff.

(2) A statement identifying the debt setoff . . . and giving the respective balances due before and after the setoff.

(3) A statement that if the customer claims that the debt has been paid or is not now owing, or that the funds in the deposit account consist of money expressly exempt . . . and listed in the notice, the customer may execute and return the notice to the bank . . . not later than 20 days after the date of mailing or personal delivery.

(4) A statement that if the notice is executed and returned, the bank may file an action in court to collect the debt, that if a lawsuit is filed, the customer will be notified and have an opportunity to appear and defend, and that if the bank is successful, the customer will be liable for court costs, and attorney's fees, if the debt so provides.

(5) A response form . . . containing substantially the following:

"The debt described in the Notice of Setoff received from the bank is _____ is not _____ my debt or the debt of another person in whose name the account is maintained.

I claim that the debt:

_____ has been paid.

_____ is not now owing.

_____ is not subject to setoff because the money in the account is:

- Paid earnings (CCP 704.070)
- Proceeds from execution sale of or insurance for loss of a motor vehicle (CCP 704.010)
- Proceeds from execution sale of household furnishings or other personal effects (CCP 704.020)
- Relocation benefits (CCP 704.100)
- Life insurance proceeds (CCP 704.120)
- Workers' compensation benefits (CCP 704.150)
- Unemployment or strike benefits (CCP 704.130)
- Retirement benefits including, but not limited to, social security benefits (CCP 704.080, 704.110, 704.115)
- Public assistance benefits including, but not limited to, social security benefits (CCP 704.080, 704.110, 704.115)
- Proceeds from sale of or insurance for damage or destruction of a dwelling (CCP 704.720, 704.960)
- Proceeds from execution sale of or insurance for loss of tools of a trade (CCP 704.060)
- Award of damages for personal injury (CCP 704.140) or wrongful death (CCP 704.150)
- Financial aid paid by an institution of higher education to a student for expenses while attending school (CCP 704.190)"
foreclose by an outside creditor or after the bank's internal decision to foreclose. The secured party would send a notice, similar to the post-repossession notice discussed above but warning of imminent foreclosure, to the debtor on the day following the freeze. The notice would inform the debtor that an enclosed form could be returned averring that the debt was not owed or that the funds in the deposit account were not subject to seizure because of insulation afforded by state exemption statutes. If the debtor returned a properly completed response form within the twenty-day period, the freeze on the deposit account would be lifted and the secured party would have to pursue other means to collect the debt. Thus, the debtor would have the opportunity to raise objections, on limited grounds, to self-help foreclosure.

In sum, if the default provisions of article 9 are to be applied to deposit account collateral, principal debtors and account debtors will need more information than the Code presently provides. Limitations on creditor self-help remedies against consumer deposit accounts also will have to be developed.

VI. CONCLUSION

More than ever before, there is a need today for a uniform,
coherent, and certain body of law regarding the rights and liabilities of parties using deposit accounts as collateral in credit transactions. Depositary institutions, recently freed from significant federal restrictions on their ability to offer a wide range of investment opportunities, will continue to attract an increasing volume of consumer and business funds. The law should afford depositors the flexibility to hypothecate this personal property—worth billions of dollars in the aggregate—in favor of the lenders they prefer.

Application of the general principles of article 9, displacing non-Code law governing the assignment or pledge of interests in bank accounts and the now obsolete common law right to set-off, is the best way to accomplish this goal. As with other secured transactions within the scope of article 9, lenders would have access to the information necessary for effective competition with respect to credit-extending opportunities and could protect their interests in deposit accounts by prompt filing. By replacing non-Code security devices in deposit account collateral with the unitary article 9 security interest, the law governing contests among creditors and between the debtor and any particular creditor, both in and out of bankruptcy, would become more certain, more equitable, and more responsive to the needs of participants in modern banking transactions.