A DEFENSE OF EXTENDING ARTICLE 9 TO COVER SECURITY INTERESTS IN DEPOSIT ACCOUNTS AS ORIGINAL COLLATERAL

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Introduction

On June 5, 1992, the Subcommittee on Deposit Accounts issued its final report to the Article 9 Study Committee of the Permanent Editorial Board for the Uniform Commercial Code. That report urged the Study Committee to recommend that the scope of Article 9 be augmented to cover security interests in deposit accounts as original collateral. The report then presented a series of comprehensive suggestions to deal with the myriad of issues raised by such a change in the law.

On December 1, 1992, the Study Committee in turn issued its report to the PEB, in which it also recommended that the current exclusion for deposit accounts be removed and that any Drafting Committee appointed “give serious consideration” to the specific recommendations in the Subcommittee’s report. The Study Committee did not fully endorse the Subcommittee’s recommendations, however, and in several key respects disagreed with the recommendations of the Subcommittee. Most particularly, the Study Committee recommended that depositary institutions have no duty to a secured party beyond those that it voluntarily assumes – presumably pursuant to contract – or that is imposed by law after service of process.

The recommendations of the Study Committee and of the Subcommittee have been somewhat controversial, and the Federal Reserve Bank of New York – two of whose representatives served on the Subcommittee – seems to have been expending its influence in opposition to the proposals. A coordinated proposal of the Uniform Commercial Code Committee of the State Bar of California for a change in the California Commercial Code also has encountered opposition, most notably from consumer groups. This proposal, which was to have been part of the Bar’s legislative agenda, appears to have stalled.

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2 Study Committee Report at 21 & 68-71.

3 Report of Uniform Commercial Code Committee on Affirmative Legislative Proposal (Sept. 30, 1992). This report, with its accompanying proposed amendments to Division 9 of the California Commercial Code was approved by the UCC Committee on May 29, 1992 and then unanimously endorsed by the Business Law Section Executive Committee on September 18, 1992. The principal authors of the report and proposed amendments were John F. Hilson and Jeffrey S. Turner, both of Brobeck, Phleger & Harrison, Los Angeles, California. A copy of the report and proposals may be obtained from either Mr. Hilson or the author of this article.

4 See Letter from Gail Hillebrand, Litigation Counsel, Consumers Union, to Joseph E. Bergeron (Nov. 3, 1992) (on file with the author).
On the other hand, some progress toward change has been made. One jurisdiction – encompassing a major banking a financial center – has pressed forward. In September, 1992, Illinois amended its commercial code to permit Article 9 security interests in deposit accounts as original collateral. It thus became the fourth state, joining California, Hawaii, and Louisiana, to depart from the Official Text of the Code in this respect. A bill recently passed by the Oklahoma legislature made it the fifth. Even more recently, in March 1993, the Article 9 Drafting Committee met in Boston, during which it spent approximately six hours discussing proposed changes dealing with deposit accounts.


7 1994 Okla. Sess. Laws ch. 143. The bill as originally proposed and passed by the Oklahoma House of Representatives on March 9, 1994 would have deleted the § 9-104 exclusion of deposit accounts. 1994 Ok. H.B. 2235. Before passing the bill, the Oklahoma Senate made some amendments which the House later concurred in. Under the final legislation, the § 9-104 exclusion remains, but the § 9-105(e) definition of “deposit account” has been so restricted that virtually all bank accounts would appear to be certificates of deposit that come within the state’s version of Article 9:

“Deposit account” means a demand, time, savings, passbook or like account maintained with a bank, savings and loan association, credit union or like organization, other than an account represented by a certificate of deposit. A certificate of deposit includes:

(i) an instrument as defined in paragraph (i) of this subsection whether the instrument is subject to Section 3-104 of this title or not because it is not payable to order;

(ii) a writing that contains both an acknowledgment by a bank as defined in subsection (1) of Section 4-105 of this title that a sum of money has been received by the entity and its promise to repay the sum of money and that it is considered to be a certificate of deposit by the entity that issues it, even if the writing provides that it is “nontransferable” or uses similar language; and

(iii) an uncertificated obligation of a bank as defined in subparagraph (ii) of this paragraph not represented by a writing but only by an entry on the books of the bank and any documentation given to the customer of the bank.

A written certificate of deposit shall be considered an instrument within the definition of paragraph (i) of this subsection, and an uncertificated certificate of deposit shall be considered a general intangible.

If this were not already sufficiently inartful and cumbersome, the legislation amended § 9-302 to provide some rather odd perfection rules: perfection by possession of a security interest in a deposit account if the certificate of deposit is an instrument; perfection by written notice to the depositary – accompanied by “reasonable proof of the claimed security interest” – if the certificate of deposit is a general intangible. Although the meaning seems evident enough, the methodology chosen makes little sense, since the interaction of §§ 9-104 & 9-105, as amended, continues to leave deposit accounts outside Article 9 by defining them to exclude certificates of deposit.
However, neither of these advances is without its drawbacks. The recent amendments to both the Illinois and Oklahoma commercial codes lack the comprehensive reforms recommended by the Subcommittee. They thus may raise as many problems as they solve. The proposals before the Drafting Committee differ in some substantial ways from those recommended by the Subcommittee and opposition to both their general concept and specific recommendations remains.

This article is not intended to defend every recommendation in the Subcommittee’s report. Nor is it designed to comment specifically on the proposals currently before the Drafting Committee, since those proposals are somewhat of a moving target. It is designed merely to help focus future discussion by highlighting some of the key issues and reviewing some of the most recent developments in the law. If digested, this article might present the following syllogism:

1. *Deposit accounts containing proceeds are currently covered by Article 9.* The official text of the Code extends the scope of Article 9 to security interests in deposit accounts as proceeds of other collateral. All discussions about whether and how to extend the scope of Article 9 must occur with unwavering appreciation of this fact, particularly since no person or interest group is advocating that the current coverage be withdrawn. Thus, it would be ineffective and possibly counterproductive to design rules that avoid placing on depositary institutions burdens and risks that such institutions already have – and would continue to have – because of the possible existence of a secured party’s interest in deposit accounts as proceeds of other collateral.

2. *There is commercial demand for Article 9 security interests in deposit accounts as original collateral.* As both case law and recent commercial transactions indicate, there is an increasing desire among lenders to take a direct security interest in deposit accounts. Since lenders are generally familiar with Article 9, whereas the rules on how to take a common-law rules security interest are unclear, lacking in uniformity, and otherwise inadequate, it makes sense to expand the scope of Article 9 to cover direct security interests in deposit accounts.

3. *Bringing direct security interests in deposit accounts within Article 9 is good for the banking industry.* Currently, depositary institutions that rely on their common-law and contractual setoff rights to defeat the rights of some third-party claimant to deposits are losing most of the litigated cases. They are certainly losing most of the cases in which a creditor with an Article 9 security interest in the deposits as proceeds also claims the funds. Indeed, they are losing cases that they should be winning, and their reliance on setoff rights is thus misplaced. Amending Article 9 is a convenient way to ensure that depositary institutions are protected by appropriate and uniform priority rules. Perhaps even more significantly, it will allow depositaries added protection against a tax lienor and the bankruptcy trustee.

4. *There is little downside to bringing direct security interests in deposit accounts within Article 9.* Concerns about the payment system and objections from consumer groups are both overstated. The integrity of the payment system is at greater risk under current law than it would be under any of the several proposals for change. Even the most “radical” proposal would present no greater burden on depositaries than does a tax levy or the bankruptcy stay. No significant consumer problems have been reported from those jurisdictions which currently extend Article 9 to security

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8 See infra notes 25, 39-40, 139-142, and accompanying text.
interests in deposit accounts as original collateral. Moreover, consumers can be additionally protected through a variety of devices. Thus, the amendment process should go forward.

The Current Scope of Article 9 – A Necessary Reference for Any Revision

The origin of the exclusion of deposit accounts from the list of those things in which a creditor may acquire an Article 9 security interest is far from clear. A recommendation for it first appeared in 1955 – without explanation – in Supplement No. 1 to the 1952 Official Text. An Official Comment, added in 1957, explained that transactions involving deposit accounts “are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law.” Commentators have since suggested, however, that it was really a political response to the objections of banks and their counsel to the Code.

The 1972 Amendments to the Code limited the exclusion to security interests in deposit accounts as original collateral, making it clear that interests claimed as proceeds were to be governed by Article 9. Although this may have been intended as a clarification rather than as a change, the Review Committee made no effort explain why the reasons for the exclusion either did not or no

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12 Vermont is the only state not to have enacted the 1972 amendments. See Vt. Stat. Ann. tit. 9A, § 9-104(k) (1966 & 1993 Supp.). Thus, a security interest in deposit accounts as proceeds of other collateral may be outside the scope of Vermont’s Article 9. Cf. infra notes 13, 15, and accompanying text.

13 See U.C.C. § 9-306(4) (implying, even before the 1972 amendments, that Article 9 governs security interests in deposit accounts as proceeds of other collateral). See also Domain Indus. v. First Security Bank & Trust Co., 230 N.W.2d 165, 167-68 (Iowa 1975) (and authorities cited therein), making the same point. But see 2 Grant Gilmore, Security Interests in Personal Property § 27.4, at 735-36 (1965) (proceeds are no longer identifiable and a security interest in them is cut off when they are deposited in a bank account); Trotter v. First Fed. Sav. & Loan Ass’n, 378 S.E.2d 267 (S.C. App. 1989) (rejecting a claim – based on the 1962 Official Text – that proceeds covered into a deposit account were governed by Article 9). South Carolina amended its commercial code to adopt the 1972 amendments before the case was decided but after the transactions in question occurred. See S.C. Code Ann. § 36-9-104(I) (Law. Co-op. 1977 & Supp. 1993). See also Harley-Davidson Motor Co. v. Bank of New England, 897 F.2d 611 (1st Cir. 1990) (noting that courts have, “with virtual unanimity, rejected Professor Gilmore’s early view”); Bank of Kansas v. Hutchinson Health Services, Inc., 735 P.2d 256, 259 (Kan. App.) (“the cases are almost unanimous in holding that proceeds are ‘identifiable’ if they can be ‘traced’ into the debtor’s bank account”), rev. denied, 241 Kan. 838 (1987).
longer applied to interests in deposit accounts as proceeds.\textsuperscript{14} To the extent that the original exclusion was motivated by concerns for the payment system – hence the designation of transactions involving deposit accounts as “special” – the 1972 amendments made no effort either to accommodate that concern or to explain why that concern was misplaced with respect to security interests in deposit accounts as proceeds.

In any event, Article 9 now clearly governs security interests in deposit accounts to the extent claimed as proceeds of other collateral.\textsuperscript{15} It also governs security interests in deposit accounts in at least two other respects. First, deposits represented by a certificate of deposit are generally covered by Article 9.\textsuperscript{16} Second, deposits held in a retirement plan or through a brokerage house may be

\textsuperscript{14} The Review Committee’s entire explanation was as follows:

Proceeds frequently find their way to bank or deposit accounts, and Section 9-306(4)(b) expressly contemplates that the secured party will have a security interest in the proceeds so deposited. But existing Section 9-104(k) provides that Article 9 does not apply to deposit accounts and similar accounts. The Committee proposes to amend the treatment in Section 9-104 so that it is not inconsistent with the recognition of proceeds security interests in these accounts, and to add in Section 9-105 a new definition of “deposit account” to cover all these types of accounts intended to be covered by these provisions.


\textsuperscript{16} See U.C.C. § 9-105(1)(e) (defining “deposit account” since the 1972 amendments to exclude those evidenced by a certificate of deposit). “Certificate of deposit” is an undefined term in Article 9. Cf. U.C.C. § 3-104(j). This has led to some controversy and confusion over three related issues regarding nonnegotiable certificates which purport to be nontransferable: (1) whether they qualify as CDs governed by Article 9 or deposit accounts excluded from coverage; (2) whether, if constituting CDs, they qualify as “instruments” under § 9-105(i) or “general intangibles” under § 9-106; and (3) whether the holder, despite the language of nontransferability, may grant a security interest in them. Professor Harris’s article remains the most authoritative scholarship on these issues. See Harris, supra note 11. See also In re Latin Investment, 156 B.R. 102 (Bankr. D.D.C. 1993) (providing an excellent and detailed analysis of several of these issues); Jamison v. Society Nat’l Bank, 611 N.E.2d 307, 310-11 (Ohio 1993) (nontransferable CD is an instrument); Prudential-Bache Securities, Inc. v. Bartow County Bank, 370 S.E.2d 751, 752-53 (Ga. App. 1988) (nontransferable CD was not an instrument, and thus security interest in it was excluded from the coverage by Article 9 as a deposit account); Alvin C. Harrell, Security Interests in Deposit Accounts: A Unique Relationship Between the UCC and Other Law, 23 UCC L.J. 153, 178 (1990) (“Nontransferable CDs should be considered a general intangible, subject to perfection by filing”); Stephen L. Sepinuck, The Problems with Setoff: A Proposed Legislative Solution, 30 Wm. & MARY L. REV. 51, 81 n.124 (1988) (citing to additional, relevant cases decided after Professor Harris’ article).
subject to direct Article 9 security interests, although the rules governing such security interests are likely to be significantly changed by the Article 8 revision process.

Any discussion about whether and how to amend Article 9 to make it cover most other security interests in deposits must take place in this context. Rules designed to avoid imposing burdens on depositary institutions with respect to security interests in deposit accounts as original collateral will be futile if such institutions have these burdens now – and will retain these burdens in any revised Article 9 – with respect to security interests in deposit accounts as proceeds. Thus, unless it is either more difficult or more manifestly more difficult for Article 9 to deal with security interests in deposit accounts as original collateral than with security interests in deposit accounts as proceeds, or the common law rules are manifestly better, there is little reason to continue the exclusion. Even the critics of expanding Article 9 do not make these arguments.

Perhaps more to the point, the current and continued existence of Article 9 security interests in deposit accounts as proceeds of other collateral is critically relevant to many of the specific issues that must be confronted when dealing with the proposed changes to Article 9. Three fairly controversial matters illustrate this: (1) the method of perfecting a security interest in a deposit account; (2) the ability of a depositary institution to contractually prohibit depositors from collateralizing funds on deposit with it; and (3) the applicability of Article 9 to security interests in transactional accounts.

**Perfecting Security Interests In Deposit Accounts**

Few people seriously argue that a depositary institution should have to file a financing statement to perfect a security interest in a deposit account it maintains. Most agree that such a

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17 See In re Nix, 864 F.2d 1209, 1211-12 (5th Cir. 1989) (security interest in Keogh plan not excluded by § 9-104(l) because plan is not a “demand, time, savings, passbook or like account” and brokerage is not a bank or “like organization”). The court’s conclusion that Keogh plans are not like deposit accounts seems correct for plans that are funded in whole or in part with stock, as the plan in question was. The court’s reasoning and language suggest, however, that security interests in plans funded entirely with deposits would still not be excluded from the scope of Article 9. See also In re Van Kylen, 98 B.R. 455, 458-62 (Bankr. W.D. Wis. 1989) (relying on Nix in concluding that a cash management account at a brokerage is not a deposit account and thus is a general intangible governed by Article 9).

18 See American Law Institute, Uniform Commercial Code Revised Article 8 Investment Securities 14-15 & 146-68 (Proposed Final Draft April 5, 1994). The proposals contained in the draft would return the rules on security interests in investment securities to Article 9, where they had been prior to the 1978 revisions to the Code. Id. at 7-8.

It would be bizarre if Article 9 continued to govern security interests in this type of investment collateral yet continued to exclude from its scope most security interests in deposit accounts, since the danger to the securities markets associated with enforcing security interests in investment property is significantly greater than the impact on the payment system that enforcing security interests in deposit accounts could possibly have.

19 Letter from Gail Hillebrand, supra note 4; Banking Law Committee of the Association of the Bar of the City of New York, Comments on Draft Report of Deposit Accounts Study Committee dated April 30, 1992 (May 28, 1992) (on file with the author); Letter from Ernest T. Patrikis, General Counsel and Executive Vice President, Federal Reserve Bank of New York, to William F. Kroener, III, Chair of the Subcommittee on Deposit Accounts (February 27, 1992) (attached as an appendix to the Subcommittee Report)
requirement is unnecessary and would overburden the filing system. Indeed, none of the four jurisdictions that has extended Article 9 to cover security interests in deposit accounts as original collateral requires the depositary with whom the funds are on deposit to file a financing statement in order to perfect. They all essentially permit a sort of automatic perfection upon attachment of the security interest.

The method by which someone other than the depositary should be permitted to perfect a security interest in a deposit account as original collateral is not so universally accepted. The Subcommittee on Deposit Accounts recommended that such creditors perfect by filing a financing statement, as they would perfect in any other general intangible. This differs from the method in California, Hawaii, Illinois, Louisiana, and Oklahoma. All of these jurisdictions require the

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20 See Subcommittee Report § 6(c), at 16 (page references are to the report itself, not to the entire volume of appendices to the Study Committee Report; the Subcommittee Report begins on page 329 of the volume of appendices):

[I]f Article 9 is amended to permit security interests in deposit accounts as original collateral, depositary institutions would modify their standard deposit account contracts to include a grant of a security interest. If such institutions were then required to file a financing statement to perfect their security interests, filing offices would be burdened with numerous additional filings, many of which would ultimately go unused. Moreover, absent legislation to the contrary . . . depositary institutions would pass the filing fees along to depositors, making it more costly for bank customers to open traditional deposit accounts and obtain traditional banking services.

With respect to a filing requirement for setoff rights, see Dan T. Coenen, Priorities in Accounts: The Crazy Quilt of Current Law and a Proposal for Reform, 45 Vand. L. Rev. 1061, 1173 n.593 (1992) (“to require all banks to go through the motion of filing financing statements to make setoff rights as to all bank depositors operable vis-à-vis third parties seems to be a low-need and high-cost approach”); BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 1.08[9], at 1-107 (2d ed. 1988) (stating that absent the section 9-104(i) exclusion of setoffs, “a blizzard of financing statements might be required”). Contra Zubrow, supra note 11, at 908.

The lack of a filing requirement for setoff is consistent with § 9-318(1), which upholds an account debtor’s defenses to payment regardless of whether notice of them has been given through a filed financing statement. See infra notes 28-37 and accompanying text.


22 Actually, the laws in each of the four jurisdictions provide that perfection by the depositary occurs at the time the security agreement is executed. See sources cited id. However, it seems doubtful that perfection should occur at that time if value has not yet been given, i.e., if there is no debt yet to secure. Compare U.C.C. §§ 9-203(1)(b) & 9-303(1). See also Subcommittee Report § 6(c), at 16; Study Committee Report at 70 (both recommending perfection upon attachment).

The current proposal before the Article 9 Drafting Committee would make the depositary perfected upon attachment by removing the filing requirement for secured parties with “control” over the deposit account and defining control to exist, among other ways, whenever the secured party is the depositary institution maintaining the deposit account. See Uniform Commercial Code Revised Article 9, Deposit Account Amendments §§ 9-118 & 9-302(1)(h), at 6 & 8 (Feb. 8, 1994 draft) (hereinafter “Drafting Committee Proposal”).

23 Subcommittee Report § 6(d), at 17-20.
nondepository secured creditor to perfect by giving notice to the depositary maintaining the account.  

The Subcommittee gave several reasons for its recommendation. Among them, it suggested that perfection by private notice to the depositary, rather than by public notice through the filing system, would interfere with the important ability of prospective creditors to easily and reliably determine relative priorities. More importantly, however, the Subcommittee noted that requiring private notice to the depositary is inconsistent with the current treatment of proceeds covered into a deposit account.

Under section 9-306(3)(b), a secured creditor retains a continuously perfected security interest in a deposit account as proceeds of other collateral if a financing statement covers the original collateral. Assuming this rule were left unmodified, it would be anomalous to require a creditor taking a direct security interest in a deposit account to give notice to the depositary in order to be perfected. Modifying this rule would place an extremely onerous burden on secured creditors.

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25 If no filing were required . . . , the only way prospective creditors could obtain reliable information about existing security interests would be from the depositary institution itself. This might necessitate a rule requiring depositary institutions to inform potential creditors of a depositor (assuming the depositor consents to the release of such information) about all security interests in a deposit account. Such a disclosure requirement would not seem to fit well within Article 9 and would be an onerous burden on depositary institutions, who at present have no system in place for collating and disseminating such information. Moreover, it could lead to liability problems if a depositary institution gives incomplete or incorrect information to a potential creditor of a depositor.

Subcommittee Report § 6(d), at 17.

The same problem could result from perfection through control. See infra note 40 (discussing the Drafting Committee Proposal). Unless the depositary informs prospective secured parties whether other creditors already have control, it will be difficult to evaluate relative priorities. Of course, a depositary that is prepared to voluntarily grant control would likely be willing to provide information about those to whom it has already granted similar control.

26 Id. at 20. The reasons given by the Subcommittee are not the same as those presented here. The Subcommittee noted that since a depositary’s setoff rights are usually primed by a proceeds claimant’s rights, depositaries should already be conducting UCC-1 searches before relying on setoff rights. A perfection-by-filing rule would then not add any new burden. See also Dag Wilkinson, Third-Party Interests in Deposit Accounts and the Bank’s Right of Setoff, 109 Banking L.J. 247, 270 (1992) (recommending that bank’s search for UCC filings before relying on setoff rights).

27 Secured creditors would have – presumably – only ten days to trace the proceeds to the correct depositary and send the appropriate notice. See U.C.C. § 9-306(3). While many provisions of Article 9 effectively require the secured party to monitor the debtor or the collateral, e.g., U.C.C. §§ 9-103(1)(d) & (3)(e), 9-307(3), 9-402(7), they usually give the debtor anywhere from 45 days to four months to react. The few provisions giving the secured party less than one month necessarily involve the creditor in the transaction. See § 9-312(4) (creditor has ten days from debtor’s receipt of the collateral to perfect a purchase-money security interest; most states allow 20 days); § 9-304(5) (creditor has 21 days to retrieve a pledged instrument temporarily returned to the debtor for some business reason). Here, the creditor would have but ten days to learn of and react to the transaction giving rise to the proceeds, and cash proceeds are the most difficult collateral to follow, the most rapidly and easily transferred, and thus the most easily concealed.
More to the point, little or no purpose would be served by requiring notice to perfect. It is not at all evident why private notice to the depositary should be necessary for a secured party to have priority over a bankruptcy trustee. Certainly such notice provides little disclosure of an otherwise secret lien.

This does not mean that notice to the depositary is or should be irrelevant. Such notice may well be important in ascertaining who has priority to the deposits. Under current section 9-318(1), the assignee of an account or general intangible takes subject to all of the account debtor’s defenses arising out of the assigned contract and all others that arise before the account debtor receives notification of the assignment. This rule is consistent with the Restatement of Contacts, and courts are increasingly using section 9-318(1) to resolve priority conflicts between a secured party and a setoff claimant, because the secured party appears to qualify as an “assignee.”

It remains a bit unclear whether a secured party whose interest arises as proceeds can also qualify as an “assignee,” since the “assignment” in such a case is at best indirect. Perhaps for this

28 U.C.C. § 9-318(1), the full text of which provides:

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

(a) all the terms of the contract between the account debtor and assignor and any defense or claim arising therefrom; and
(b) any other defense or claim of the account debtor against the assignor which accrues before the account debtor receives notification of the assignment.

29 Restatement (Second) of Contracts § 336 (1981).


31 See In re Apex Oil Co., 975 F.2d at 1368; Bank of Waukaee v. Rochester Cheese Sales, Inc., 906 F.2d at 1189-90; In re Otha C. Jean & Associates, Inc., 152 B.R. at 222-23. See also In re Metropolitan Hosp., 131 B.R. 283 (E.D. Pa. 1991); Pioneer Commercial Funding Corp. v. United Airlines, Inc., 122 B.R. at 882; Mississippi Bank v. Nickles & Wells Constr. Co., 421 So. 2d 1056 (Miss. 1982); American Bank of Commerce v. City of McAlester, 555 P.2d 581 (Okla. 1976); Donald P. Board, The Scope of Article 9 Is Only One Quarter as Great as Is Commonly Supposed, 47 U. Miami L. Rev. 951, 1037 n.238 (1993) (the code’s notion of “assignment” includes both assignments and encumbrances); Subcommittee Report § 8(b) at 31 n.80 (“presumably, although Article 9 is presently unclear on this, § 9-318 applies to accounts assigned as collateral, as well as to accounts assigned outright”); 2 Gilmore, supra note 13, § 41.10, at 1116 (describing the debtor in a secured transaction as “the ‘assignor’ under § 9-318” and the secured party as the assignee). But see In re Gibson Group, Inc., 126 B.R. 759 (Bankr. S.D. Ohio 1991) (secured party not an assignee until it seeks to enforce its rights against the account debtor; criticized in In re Otha C. Jean & Associates, Inc.).

32 Cf. GECC v. Deere Credit Services, Inc., 799 F. Supp. 832, 835 (S.D. Ohio 1992), in which the court ruled that a creditor secured in chattel paper as proceeds of collateralized inventory was not an “assignee” within the meaning of § 9-318. The analysis is rather confused, but it appears that the court concluded that the collateral’s classification as chattel paper, and not its status as proceeds, was what prevented the secured party from being an “assignee.” In any event, the court offered no reason why a party secured in chattel
reason courts do not seem to be using § 9-318(1) to deal with the competing rights of a creditor with a security interest in a deposit account as proceeds of other collateral and the depositary seeking to set off mutual obligations. Nevertheless, the rules in section 9-318(1) would appear to apply to such disputes. Certainly the depositary qualifies as an “account debtor,” since the depositor’s rights against it are an unsecured claim constituting a general intangible.

See infra notes 101-107 and accompanying text dealing with depositaries’ setoff rights. It may also be because many of the disputes involve a secured party and a bank obligated on a CD. See, e.g., Citibank v. InterFirst Bank, 784 F.2d 619 (5th Cir. 1986); Credit Alliance Corp. v. National Bank, 718 F. Supp. 954 (N.D. Ga. 1989); Republican Valley Bank v. Security State Bank, 426 N.W.2d 529 (Neb. 1988); Texas Bank & Trust Co. v. Spur Second Bank, 705 S.W.2d 349 (Tex. App. 1986); State Bank v. First Bank, 320 N.W.2d 723 (Minn. 1982). Because a CD generally qualifies as an instrument, see supra note 16, a bank obligated on it would not qualify as an account debtor under § 9-105(1)(a), at least not unless the instrument were part of chattel paper, and thus § 9-318(1) would not apply. See Citizens Nat’l Bank v. Bornstein, 374 So. 2d 6, 13 (Fla. 1979); Board, supra note 31, at 1037-39; Sepinuck, supra note 16, at 80-82. See also Frances A. Rauer, Conflicts Between Set-Offs and Article 9 Security Interests, 39 Stan. L. Rev. 235, 261 & n.96 (noting that § 9-318 does not apply to a setoff of the depositary’s debt on a CD).

But cf. Rauer, supra note 33, at 261 & n.96, suggesting that § 9-318 never applies when the setoff claimant is a bank. The only support Rauer provides for that conclusion is Roosevelt Fed. Sav. & Loan Ass’n v. First Nat’l Bank, 614 S.W.2d 289 (Mo. App. 1981). That case involved a pledge of the deposit account as original collateral — a transaction not governed by Article 9 — not a claim to deposited proceeds that would be governed by Article 9. Admittedly, some more recent authority does support Rauer’s point. Compare Bank of Kansas v. Hutchinson Health Services, Inc., 773 P.2d 660, 662 (Kan. App. 1989) (ruling that § 9-318 governs the dispute between a setoff claimant and a secured party), aff’d 785 P.2d 1349 (Kan. 1990), with Bank of Kansas v. Hutchinson Health Services, Inc., 735 P.2d 256, 260-61 (Kan. App.) (ruling that § 9-201 governs the dispute between a bank with setoff rights and a secured party), rev. denied, 241 Kan. 838 (1987). In the later case, the court actually suggested that the analysis is in any way dependant on whether the claimants are banks, but on whether the setoff claimant was an account debtor. 773 P.2d at 664. In neither case did the court actually discuss whether the bank was an account debtor. See infra note 35. See also Barkley Clark, Bank Exercise of Setoff: Avoiding the Pitfalls, 98 Banking L.J. 196, 219 (1981) (stating that a priority contest between a secured party and a bank with setoff rights should not be governed by Article 9 because of the § 9-104(i) exclusion, but never discussing § 9-318).

The depositary is not a bailee of the deposited funds, but simply a debtor of the depositary. See, e.g., Miller v. Wells Fargo Bank Int’l Corp., 540 F.2d 548, 560 (2d Cir. 1976); In re Interstate Dept. Stores, Inc., 128 B.R. 703, 705 (Bankr. N.D.N.Y. 1991); In re CJL Co., 71 B.R. 261, 265 (Bankr. D. Or. 1987); In re Zimmerman, 69 B.R. 436, 438 (Bankr. E.D. Wis. 1987); In re Hecht, 41 B.R. 701, 704 (S.D.N.Y. 1984); In re Amco Products, Inc., 17 B.R. 758, 762 (Bankr. W.D. Mo. 1982); Trotter v. First Fed. Sav. & Loan Ass’n, 378 S.E.2d 267, 269 (S.C. App. 1989); First Bank v. Samocki Bros. Trucking Co., 509 N.E.2d 187, 198 (Ind. App. 1987) (all noting that title to deposited funds passes to bank; the relationship of depositor to bank is that of creditor to debtor). See also Restatement (Second) of Trusts § 12 comment l (1959) (“A general deposit of money in a commercial bank does not create a trust, but a relation of debtor and creditor”). ALI, supra note 18, at 14 (“A deposit account . . . is simply a debtor-creditor relationship”). In short, the depositor simply has an unsecured claim against the depositary. Thus, a deposit account is essentially a type of general intangible and the depositary is an account debtor. See U.C.C. § 9-105(1)(a). See also Subcommittee Report §§ 3 & 6(a), at 6 & 14 (absent a new classification, deposit accounts would qualify as general intangibles unless certified in a manner that complies with § 9-105(i)); BARKLEY CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS ¶ 14.14, at S14-7 (3d ed. 1990 & Supp. 1993) (“If uncertificated bank accounts were within the scope of Article 9, they would presumably qualify as ‘general intangibles’”); In re Laves, 90 B.R. 158, 162 (Bankr. E.D.N.C. 1988) (“The Credit Union does not hold the deposit as bailee of the debtor, but as the debtor’s account debtor”). But see Marquette Nat’l Bank v. B.J. Dodge Fiat, Inc., 475 N.E.2d 1057, 1061 (Ill. App. 1985) (suggesting that a deposit account is not a general intangible because
Thus, under current law, a secured party whose proceeds are covered into a deposit account would appear to lose to all of the depositary’s setoff claims arising out of the depositary relationship and all others that arose before the depositary received notice of the security interest. This means that the main justification for the notice-to-perfect rule—allowing the depositary to extend credit in reliance on deposited funds without having to search numerous public records for competing claims to those funds—simply fails; the intended benefit already exists. In short, rather than using a perfection rule, the depositary’s reliance interests are and can be protected through a priority rule—whether in section 9-318 or elsewhere in Article 9—that does not undermine the secured creditor’s rights against a bankruptcy trustee.

One trouble with not requiring private notice to perfect but interpreting section 9-318 as making such notice necessary to obtain priority over the depositary, is that circular priorities can result. Consider, for example, the following scenario: Creditor One obtains a security interest in a deposit account on February 2, and files a financing statement adequately describing the collateral that day. Creditor Two takes a security interest in the same collateral on March 3. On that date, Creditor Two also files a financing statement and notifies Bank, the depositary institution, of its interest. On April 4, without having received any notification from Creditor One, Bank extends credit to the depositor. Absent some special resolution to this conflict, the rules discussed above would have Creditor One defeat Creditor Two, Creditor Two defeat the Bank, and the Bank defeat Creditor One. Of course, this problem is not new; it can currently arise under section 9-318(1) with respect to security interests in any monetary obligation constituting an account or general intangible. Still, it is a formidable problem.

One possible solution to this is to always give the depositary priority over other perfected interests in a deposit account it maintains. Of course, if this were done there would be little reason to give the depositary notice of a competing interest. Alternatively, priority among all creditors

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36 In other words, recoupment claims. See U.C.C. § 9-318(1)(a).

37 See Subcommittee Report § 6(d), at 18.

Such a search would be much more cumbersome than simply checking with one filing office. A secured party claiming an interests in a deposit account as proceeds is most likely to have had either accounts or inventory as original collateral. Account finance rs would generally need to file only in the jurisdiction where the debtor is located, U.C.C. § 9-103(3), and thus depositaries would need to search only there to locate effective notices. Inventory financers, on the other hand, would generally need to file wherever the goods are located. U.C.C. § 9-103(1). If the debtor were a large, multi-state business, the depositary would need to search in numerous jurisdictions to fully protect itself. Of course, this burden is no different than what any accounts financer would have in order to protect itself from a prior inventory financer.

38 With minor changes, the same problem can arise if the deposit account contains proceeds of other collateral: Creditor One obtains a security interest in collateral on February 2, and files a financing statement adequately describing the collateral that day. Creditor Two perfects a security interest in the same collateral by filing on March 3. On April 4, the debtor converts the collateral into cash proceeds, which are then deposited with Bank. One week later, Creditor Two properly notifies Bank of its interest in the debtor’s deposit account. On May 5, without having received any notification from Creditor One, Bank extends credit to the depositor.

39 Subcommittee Report § 6(d), at 18. The proposals recently discussed by the Drafting Committee would grant the depositary priority over any other secured party. Drafting Committee Proposal § 9-312(x), at 8-9. However, at its meeting in Boston the Drafting Committee and its advisors provisionally voted to reject such a rule and to allow a secured party claiming an interest in a deposit account as proceeds to defeat a depositary who perfected subsequently. The Drafting Committee did not focus on whether notice to the

the definition of “general intangibles” excludes money).
not merely between creditors and the depositary – depend on whether the depositary (e.g., the account debtor) has received notice. In other words, to have the priority between Creditor One and Creditor Two rest on who both perfected and gave notice first. The drawback to this is that Creditor Two would prime Creditor One’s interest in proceeds covered into a deposit account if it learned of the transaction and sent its notice first. In short, if the depositary is not claiming any defense to payment, it is unclear why Creditor Two should be allowed to have priority over Creditor One.

However one chooses to resolve the section 9-318(1) circular priority problem – and it should be resolved for all account debtors, not merely for depositaries – resolution should be by a priority rule, not by a perfection rule. A perfection rule unnecessarily interferes with the rights of proceeds claimants. Moreover, while an appropriate priority rule may well take into account whether and when the depositary received notice of another creditor’s security interest, that rule should not depend on whether the depositary agreed to be bound by or otherwise recognize that interest, as the current proposal before the Drafting Committee does. Such a rule would also interfere with the rights of creditors in proceeds.

Anti-Pledge Restrictions on Deposit Accounts

Contractual prohibitions on the right of a depositor to collateralize a deposit account must similarly be examined in light of Article 9’s current rules regarding proceeds. At present, section 9-318(4) prohibits an account debtor from restricting its creditor’s right to assign or collateralize the right to receive payment. This rule is a departure from common-law principles as traditionally stated, although perhaps not from common-law cases as actually decided. It was a response to a
perceived economic need for the free alienability of intangible rights, and Grant Gilmore described it as one of Article 9’s “most useful contributions.” Prohibitions on anti-assignment clauses are thus grounded in public policy and they represent the clear trend throughout modern contract law. More to the point, since depositary institutions appear to qualify as account debtors, Article 9 currently prohibits them from restricting the depositors’ ability to collateralize their deposits, at least to the extent the deposited funds are proceeds of other collateral.

The Subcommittee recommended that this prohibition be maintained and extended to all security interests in deposit accounts, if Article 9 is broadened to cover security interests in deposit accounts as original collateral. That recommendation has met with some resistance. The Study

44 See U.C.C. § 9-318 comment 4. Indeed, the 1972 amendments to Article 9 broadened the scope of § 9-318(4) from dealing solely with accounts to dealing with accounts and general intangibles.

45 1 GILMORE, supra note 13, § 12.8, at 391.

46 See also U.C.C. § 2-210(2) (making the right to damages for breach of a sales contract and the rights arising from full performance of a sales contract freely assignable despite the contracting parties’ agreement otherwise.

Although the new Restatement of Contracts did not adopt such an anti-assignment prohibition, it did change the rules to create a various presumptions against anti-assignment clauses. Compare Restatement of Contracts § 151(c) (1932) with Restatement (Second) of Contracts §§ 317(2)(c) & 322 (1981). See also 11 U.S.C. § 541(c)(1)(A) (making contractual anti-assignment provisions ineffective to prevent a bankruptcy trustee from acquiring property rights from the debtor.

Free alienability of rights in property may also be incorporated in the upcoming revisions to Article 8. Early suggestions for revising that Article made security interests in securities entitlements subject to the consent of the broker maintaining the entitlement account. The current draft, however, has altered this rule. It provides that a secured party cannot have “control” over a securities entitlement maintained in the debtor’s name without the agreement of the broker maintaining the account. ALI, supra note 18, § 8-106(d). However, it provides that perfection need not occur through “control”; it can occur through filing a financing statement. Id. § 9-115(4). The benefit of perfection through control would be in the priority accorded it. Id. § 9-115(5) & (6).

47 A deposit account would appear to qualify as a general intangible, making the depositary an “account debtor.” See supra note 35 and accompanying text.

48 Although restrictions on assignment are no doubt ineffective to prevent assignment, see, e.g., Mississippi Bank v. Nickles & Wells Constr. Co., 421 So. 2d 1056 (Miss. 1982), it remains unclear whether they are thoroughly void. Perhaps they can have other limited effect, such as by rendering an assignment a default on the contract with the account debtor. After all, it is common practice for security agreements to include a promise by the debtor not to grant further security interests in the collateral without the creditor’s consent. But cf. American Bank of Commerce v. City of McAlester, 555 P.2d 581, 585 (Okla. 1976) (although not speaking to this issue, describing contractual restrictions on the assignable of accounts as “contra to law, and thus null and void”).

The Subcommittee stated:

49 allowing depositary institutions to have this kind of veto on security interests would be contrary to existing Code policy. Article 9 already declares ineffective all contractual provisions which prohibit the granting of a security interest in an account or general intangible. It adopted this approach in part to reflect the prevailing trend in the law, but mostly “in response to economic need: as accounts and other . . . rights have become the collateral which secures an ever increasing number of financing transactions, it has been necessary to reshape the law so that these intangibles, like negotiable instruments and negotiable documents of title, can be freely assigned”.

Committee recommended that the depositary have no obligations with respect to a security interest in a deposit account beyond those that it voluntarily assumes or a court orders. This suggests that the Study Committee wished to permit a depositary to prohibit collateralization of the deposit accounts it maintains, although it may be better understood merely as a concern about enforcement procedures. Some bank counsel have expressed more direct and emphatic concern over the Subcommittee’s recommendation. Perhaps most significantly, Illinois and Louisiana have abrogated the section 9-318(4) prohibition by effectively requiring the consent of the depositary to collateralization of a deposit account.

Whatever perceived interests have prompted the actions of these two States and the complaints of bank counsel could be dealt with more than adequately in other ways. Moreover, none of these parties has adequately accounted for the possible existence of security interests in deposit accounts as proceeds of other collateral. Assuming the current law dealing with security


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50 Study Committee Report at 21 & 68.

51 See id. at 71. But cf. Drafting Committee Proposal § 9-106, at 3 (making “deposit accounts” a separate classification of collateral, rather than a type of general intangible). If the current Drafting Committee Proposal were enacted, a depositary could presumably prevent its depositors from collateralizing their deposits with anyone but the depositary institution itself.

52 See infra notes 121-123 and accompanying text.


Illinois did not originally adopt this rule. When the State amended its commercial code in September, 1992 to permit Article 9 security interests in deposit accounts as original collateral, it required that the secured party merely give notice to the depositary. Pub. Act 87-1037, 1992 Ill. Legis. Serv. 2156 (West). Then, in December, in legislation dealing with a hodgepodge of matters involving financial institutions, it added the requirement of consent. Pub. Act 87-1242, 1992 Ill. Legis. Serv. 3523 (West). There was no floor discussion of this matter beyond a simple statement that its purpose was to clarify that creation of a security interest “does not eliminate the common law right of set off of the” depositary. Ill. H.R., 87th Gen. Assem., Transcript Debate 2 (Dec. 2, 1992). Of course, requiring consent goes well beyond what would be necessary to protect setoff rights, which the September legislation to some extent already had. See Pub. Act 87-1037, amending the Illinois version of § 9-102.

In any event, it is worth noting that Illinois did not amend its § 9-318(4). Thus, it may well be that a third-party secured creditor cannot perfect a security interest in a deposit account without the depositary’s consent, but that the security interest may attach despite an objection by the depositary or a contractual prohibition on assignment.

54 To the extent depositaries need protection for their own rights to or interests in the deposit account, such rights and interests can be protected more directly and precisely through priority rules. To the extent that the depositary’s interests as stakeholder and as conduit to the payment system are what need protection, those interests can be dealt with more directly and precisely through rules on the enforcement of security interests. There is thus no need to allow a depositary to prohibit its depositors from collateralizing their deposits.

55 Compare Chrysler Credit Corp. v. Whitney Nat’l Bank, 798 F. Supp. 1234, 1242 (E.D. La. 1993) (suggesting that a depositary’s effort to prohibit its depositor under § 6:312(e) from collateralizing a deposit account cannot prevent a security interest in proceeds from continuing even after their deposit into that
interests in deposit accounts as proceeds remains unchanged, then it is unclear what would be gained by allowing a depositary to prohibit its depositors from using their deposits as original collateral. The depositary would still have to be concerned with potential third-party claims to the deposits. If, on the other hand, the current rules were changed and a depositary were permitted to prevent attachment of a security interest to proceeds deposited with it – if it were essentially permitted to cut off a secured party’s interest in proceeds – the impact on traditional financing arrangements would be extreme. Accounts and inventory financing in particular would be greatly compromised, and creditors would have to use more cumbersome and more costly procedures to protect their interests.

Applicability of Article 9 to Security Interests in Transactional Accounts

The Subcommittee recommended that Article 9 cover security interests in almost all types of deposit accounts, including transactional accounts such as those on which the depositor frequently writes checks.\(^{56}\) As with the perfection issue, it gave several reasons for its recommendation, including the difficulty of creating a meaningful and workable distinction between transactional and nontransactional accounts. Of principal importance, however, is the point it made in passing: transactional accounts are already within the scope of Article 9. Under the current law, to the extent proceeds of Article 9 collateral are deposited into a checking account, Article 9 continues to govern the rights of the debtor and of the secured party.

Unless we are willing to backtrack, to conclude the 1972 amendments were a mistake and that Article 9 secured parties should lose their rights to proceeds once deposited in a checking account,\(^{57}\) then we need some principled basis for concluding that security interests in transactional accounts as original collateral are materially different from security interests in transactional accounts as proceeds. Such a principled basis is difficult to find.\(^{58}\) The reason generally offered for excluding security interests in transactional accounts from the scope of any amended Article 9 is to protect the payment system. Yet even if Article 9 coverage of transactional accounts did pose such a danger, it is a danger that both already exists and would be removed by either the Subcommittee’s recommendations or the proposals currently before the Drafting Committee.\(^{59}\) Thus, as long as proceeds covered into a deposit account continue to be governed by Article 9, concern for the payment system cannot be an adequate basis for refusing to expand Article 9 to cover all security interests in deposit accounts.

\(^{56}\) Subcommittee Report § 4(e), at 11-12.

\(^{57}\) Such a decision seems very unlikely. It would present an administrative nightmare for, among others, inventory and accounts financiers. Such lenders might attempt to establish some lock-box arrangement for proceeds, but even that may prove ineffective. If such lenders are not themselves depositary institutions, they may be unable to perfect a common-law security interest in a transactional account to which the debtor has routine access. See infra notes 78-80 and accompanying text. If they restrict the debtor’s access in an effort to perfect a common-law interest, the debtor’s process of doing business becomes more costly and less efficient.

\(^{58}\) Cf. CLARK, supra note 35, ¶ 14.14, at S14-6 (“there seems to be no good reason that a secured lender should not be able to claim an enforceable security interest in any bank account of the debtor, so long as it is recognized that a lien on a transaction account is not nearly as safe as one against a restricted account”).

\(^{59}\) See infra notes 129-149 and accompanying text.
The Inadequacy of the Common Law and the Need for Expanding Article 9

The original exclusion of security interests in deposit accounts from the coverage of Article 9 may have been motivated by the conclusion that deposit accounts financing was a rare and unneeded type of commercial financing or by the belief that common-law rules adequately dealt with the arrangement. At the current time, both of these points are demonstrably incorrect.

As for the utility of deposit accounts financing, it is interesting to note the apparent increase in litigation involving claimed security interests in deposit accounts. Although it is difficult to make an exact determination, almost all of the published decisions concerning the validity or perfection of a common-law security interest of a depositary institution in an account it maintains were decided after 1980, with most after 1985.60 Similar statistics exist for cases concerning the validity or perfection of a third party’s common-law interest in a deposit account.61 In fact, one court recently commented that obtaining a security interest in deposit accounts was a common financing technique.62 Thus, even if deposit accounts financing was uncommon in Gilmore’s time, it appears


to gaining in popularity. Indeed, at least one court has suggested that the exclusion of deposit accounts from Article 9 no longer comports with the reality of modern commercial financing.\textsuperscript{63}

Perhaps more importantly, in some types of deals deposit accounts financing is essential. For example, the only significant asset of a corporation in the business of cashing checks and issuing money orders may be its deposit accounts, particularly if its business offices consist of leaseholds with little realizable value.\textsuperscript{64} Counsel in California have reported that the financing of at least one such business has gone forward only because it was possible to take an Article 9 security interest in the business’ deposit accounts in that state.

The rules regarding how to obtain an enforceable common-law security interest against a deposit account have been the source of much discussion lately.\textsuperscript{65} In their contribution to this discussion, Professors Zubrow and Greene have ably described the current state of law and its historical development.\textsuperscript{66} Their efforts have made a detailed exploration of that material unnecessary here. Moreover, in at least one sense, Professor Greene is quite correct that the common law is “alive and well.” Cases such as \textit{Duncan Box}\textsuperscript{67} are masterful examples of the judiciary’s ability to adapt the common law to changing circumstances.

In that case, to obtain financing from a bank, the depositor opened a reserve account at the bank. Pursuant to this arrangement, the debtor had no access to the reserved deposits: the bank controlled all access. After the debtor went out of business, two judgment creditors attached the reserve account.\textsuperscript{68} In dealing with the priority dispute between the bank and the attaching creditors, the court unequivocally abandoned the requirement of an indispensable instrument for an effective pledge of an intangible. The court held that a deposit account not reified in an indispensable instrument could be pledged by contractually transferring control over it to the pledgee.\textsuperscript{69}

Yet in another sense, the common law may be “alive” but it is far from “well.” It is simply too slow and too unreliable. Almost fourteen years after \textit{Duncan Box}, the rules regarding security

\begin{footnotesize}
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\item See In re Van Kylen, 98 B.R. 455, 461 (Bankr. W.D. Wis. 1989):
\item The deposit account exception is based on the notion that security interests in savings accounts, etc. are not the stuff of commercial secured financing. See G. Gilmore, \textit{Security Interests in Personal Property} § 10.7 at 316 (1965) (exclusion for deposit accounts “reflect[s] the thought that such transfers are beyond the pale with respect to a statute devoted to commercial financing”). Whether the reality of today’s commercial practice comports with the drafter’s perceptions of commercial financing at the time the exception was drafted is an open question. It is unlikely that the drafters of Article Nine envisioned the existence of hybrid accounts of this type, much less their serving as collateral for commercial loans.
\item As used here, “common-law security interest” means any sort of arrangement, such as pledge or assignment, by which a person can acquire a consensual lien enforceable without resort to judicial process. It does not include most setoff rights under this label, because they generally arise by operation of law.
\item See Greene, supra note 11, at 295-308; Zubrow, supra note 11, at 936-41.
\item Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140 (W. Va. 1980).
\item \textit{Id.} at 141-42.
\item \textit{Id.} at 144-46.
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interests in deposit accounts, whether by way of assignment or pledge, remain complex and unclear. There are no certain rules about the steps necessary to take a common-law security interest in a deposit account; numerous attempts to acquire one have failed.\textsuperscript{70} One court even held a common-law interest effective as to the principal deposited but not as to the interest that accrued.\textsuperscript{71} Indeed, despite \textit{Duncan Box}, there is no uniform agreement about whether the indispensable instrument requirement still exists.\textsuperscript{72} Moreover, several recent authorities suggest that the depositary cannot acquire a valid lien on a deposit account it maintains because it cannot have a lien on its own property.\textsuperscript{73}


\textsuperscript{71} Prudential-Bache Securities, Inc. v. Bartow County Bank, 370 S.E.2d 751. The decision was based on the lack of reference in the contract documents to interest. The court never discussed whether usage of trade would make such reference unnecessary. \textit{Cf.} \textit{Restatement (Second) of Contracts} §§ 219-222 (1981). \textit{See also} \textit{U.C.C. §§ 1-201(3) (defining “agreement” to include trade usage); 1-205(2) & (3) (defining “usage of trade” and indicating it supplements the terms of any agreement).}

\textsuperscript{72} \textit{Compare} \textit{In re CJL Co.}, 71 B.R. 261; \textit{Duncan Box & Lumber Co. v. Applied Energies, Inc.}, 270 S.E.2d 140 (both concluding that the depositary had an effective common-law pledge – not of funds, but of intangible right to withdraw them – through restrictions placed on the deposit account) \textit{with} \textit{Peoples Nat'l Bank v. United States}, 777 F.2d at 461-62; \textit{Miller v. Wells Fargo Bank Int'l}, 540 F.2d at 561-63 (both stating that there can be no effective pledge of an intangible right yet also discussing whether the debtor’s access to the deposits was truly restricted). \textit{See also} \textit{United States v. Bell Credit Union}, 860 F.2d 365, 369-72 (10th Cir. 1988) (stating that an indispensable instrument is necessary to effectively pledge a deposit account, but not discussing \textit{Duncan Box}); \textit{Iser Elec. Co. v. Ingran Constr. Co.}, 362 N.E.2d 771, 773 (Ill. App. 1977) (never clearly dealing with garnishor’s challenge to perfection of common-law security interest in deposit account because debtor retained right to withdraw funds); \textit{La. Rev. Stat.} § 6:316(b) (1986 & Supp. 1994) (“The ability of the depositor to withdraw funds from a deposit account at will shall not be deemed to adversely affect the validity of the pledge provided under this Section”).

\textsuperscript{73} \textit{See United States v. Citizens & S Nat’l Bank}, 538 F.2d 1101, 1106 (5th Cir. 1976); \textit{United States v. Third Nat’l Bank}, 589 F. Supp. 155, 157 (M.D. Tenn. 1984); \textit{In re Cravey & Assocs., Inc.}, 109 B.R. 472, 473 (Bankr. M.D. Fla. 1989); \textit{In re Laues}, 90 B.R. 158, 161 (Bankr. E.D.N.C. 1988); \textit{In re Union Cartage Co.}, (Bankr. N.D. Ohio, Sept. 27 1983) (available on LEXIS); \textit{In re Amco Products, Inc.}, 17 B.R. 758, 762 (Bankr. W.D. Mo. 1982). The court in \textit{Amco Products} later distinguished special deposits which do not become property of the depositary from general deposits which do: “Had this account been a special deposit, the Bank could have obtained a lien against the property. However, since this account was a general deposit for a specific purpose, setoff is the only right to which the Bank is entitled.” 17 B.R. at 764.

Although there may be a conceptual problem with permitting a creditor to acquire a lien in its own indebtedness, \textit{see} \textit{Subcommittee Report} § 2, at 5 n.10 (citing various authorities), nothing in Article 9 currently prevents a creditor from acquiring a security interest in its own indebtedness. \textit{See id.} at 5 & n.11 (citing various authorities).
Even in those jurisdictions where the law is clear, it remains inadequate for several reasons. First, it may be impossible for a creditor to obtain a common-law interest in the deposit account if the depositor’s contract with the depositary prohibits assignments or if the depositary otherwise refuses to grant or recognize control in anyone other than the debtor. Second, use of a pledge makes perfection by multiple secured parties problematic. Both of these problems limit the debtor’s source of financing. Third, perfecting a common-law interest may involve higher transaction costs than a traditional Article 9 security interest would entail. Fourth, and most importantly, it prevents the debtor from continuing to use the deposit account in the ordinary and legitimate course of its business. This restriction is contrary to the general scheme and underlying policies of Article 9, which allows the debtor access to and use of most collateral. In short, even

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74 For example, to have an effective common-law security interest in a deposit account in Massachusetts the creditor must have possession of the documents necessary to make withdrawals. See In re Clinton Hosp. Ass’n, 142 B.R. 601, 605 (Bankr. D. Mass. 1992). Compare Heffernan v. Wollaston Credit Union, 567 N.E.2d 933, 935-37 (Mass. App. 1991) (relied upon in In re Clinton), in which one of two joint depositors signed an agreement “pledging” a portion of the funds in a passbook account to secure a loan. The depositary placed a computer hold on the account to prevent withdrawal of a portion of the funds, but permitted the depositors to retain the passbook and to make transactions, including withdrawals of the funds not subject to the computer hold. The borrower then died before repaying the loan and the depositary repaid itself from the funds in the account. The court suggested that delivery of the account documents is necessary to create a common-law pledge of a deposit account but nevertheless held that the computer restriction on withdrawals was sufficient to allow it to prevail over the surviving joint depositor on equitable principles. Compare Lynch v. County Bank, 1993 LEXIS 299 (Del. Super. 1993) (upholding depositary’s lien against surviving joint tenant even though apparently no restrictions were place on the debtors’ access to the deposited funds). Of course, equitable principles that help the depositary defeat the depositor nevertheless leave the depositary’s priority over other creditors very uncertain. Indeed, the court expressly noted that the surviving depositor was not a creditor of the borrower and had not relied on the depositors’ retention of the passbook. Heffernan, 567 N.E.2d at 937.

75 Harrell, supra note 16, at 176 (noting that since a common-law pledge traditionally requires that the secured party somehow deprive the debtor of control over and access to the deposit account, “it may be difficult very (or impossible) to meet that test, absent the cooperation of the depositary”). Cf. Iser Elec. Co. v. Ingran Constr. Co., 362 N.E.2d 771 (Ill. App. 1977) (refusing to let a garnishor claim the benefit of an anti-assignment provision in the deposit contract, but not indicating whether the depositary could rely on it). Compare CLARK, supra note 35, ¶ 14.14, at S14-7 (suggesting that courts should apply by analogy U.C.C. § 9-318(4), discussed supra notes 42-55 and accompanying text, which makes anti-assignment clauses ineffective to prevent assignment or collateralization of accounts and general intangibles).

76 Although a subsequent creditor may be able to perfect a common-law pledge in a deposit account by simply giving notice to a prior pledgee, see In re Housecraft Indus., USA, Inc., 155 B.R. 79 (Bankr. D. Vt. 1993) (so ruling in a very well reasoned opinion), if the prior pledgee is unwilling to act as a bailee for the junior secured party or the debtor and the prior pledgee had agreed that the collateral would not be pledged further, such notice may be ineffective. See id. at 90-91 (and cases discussed therein).

77 See Greene, supra note 11, at 345.

78 In re CJL Co., 71 B.R. 261, 266 (Bankr. D. Ore. 1987) (“if a depositor has the right to make withdrawals, there cannot be a valid pledge of the depositor’s rights to the account); Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140, 146 n.11 (W. Va. 1980).

79 In transactions governed by Article 9 the debtor may continue to use and control the collateral while the secured party remains perfected. U.C.C. § 9-205 (“A security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use, commingle or dispose of all or part of the collateral”). See also U.C.C. § 1-102(2) (Code policy is to facilitate commercial transactions and modernize the law governing them). The only exception would be for collateral classified as instruments, which the secured party must generally possess to perfect its interest. See § 9-304(1). Yet even with instruments the debtor may regain
those courts that have been adept in adapting the common law of pledge to intangibles like deposit accounts, by dispensing with the requirement of an indispensable instrument, have still required that to have an effective pledge the secured party must have exclusive control over the deposits.\footnote{80}

Finally, although the pledgee may have priority under the common law over subsequent garnishors and judgment creditors,\footnote{81} it is not clear that it would have priority over a subsequent Article 9 secured party claiming the account as proceeds of other collateral. This is in part because section 9-201 can be read as resolving the priority question in favor of the Article 9 secured party.\footnote{82} Under such an interpretation of Article 9, the desirability of a common-law interest is seriously undermined. If Article 9 were deemed not to resolve the priority issue, creditors with common-law security interests might have a better chance of success over subsequent Article 9 claimants,\footnote{83} but the issue would be much more difficult to resolve. Only one published decision has discussed the relative priorities of an Article 9 secured party and a person with a common-law pledge or assignment of a deposit account.\footnote{84} That court, in a well reasoned analysis, looked to Article 9 for possession for almost any business reason while the secured party remains perfected. See § 9-304(5)(a). See also \textit{1 Gilmore supra} note 13, § 14.6.2, at 459 (§ 9-304(5)(b) permits the secured party to remain perfected while temporarily surrendering the instrument for purposes which “include everything that could rationally be done with an instrument except, perhaps, having it framed and hung on the wall”). Moreover, if the instruments constitute part of chattel paper, the secured party need not take possession at all, but may perfect by filing. See \textit{U.C.C. § 9-304(1)}. See also \textit{U.C.C. § 9-105 comment 3} (making it clear that an instrument retains its character as such even though constituting part of chattel paper).

\begin{itemize}
  
  Any argument that this type of collateral is so “special” that the debtor should never have access to it proves too much. An unscrupulous debtor can almost always get to and dispose of the collateral. For example, even after a traditionally effective common-law pledge of a passbook, the secured party need not take possession at all, but may perfect by filing. See \textit{Great Am. Ins. Co., v. Hibernia Nat’l Bank}, 506 So. 2d 186 (La. App. 1987).

  \begin{itemize}
    \item \textit{See Vaughn Flying Service, Inc. v. Costanza}, 590 F. Supp. at 1079; \textit{Prudential-Bache Securities, Inc. v. Bartow County Bank}, 370 S.E.2d at 753; \textit{Bullock v. Foster Cathead Co.}, 631 S.W.2d at 211; \textit{Duncan Box & Lumber Co.}, 270 S.E.2d at 146; \textit{Iser Electric Co. v. Ingran Construction Co.}, 362 N.E.2d at 774-79.

    \begin{itemize}
      \item U.C.C. § 9-201: “Except as otherwise provided by this Act, a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors.”
    \end{itemize}

    Some courts interpret this general rule to mean that Article 9 secured parties have priority over creditors with rights not otherwise governed by Article 9. See cases cited infra note 103 (holding that the secured party defeats the setoff claimant). See also \textit{Coenen, supra} note 20, 1160-61 & n.536 (criticizing this line of authority); \textit{Board, supra} note 31, at 1006-12 & 1033-35; \textit{Sepinuck, supra} note 16, at 82-84. It is interesting to note, however, that Gilmore referred to § 9-201 not as a priority rule, but as a provision guaranteeing freedom of contract by validating the right of the debtor and secured party to agree to after-acquired property and future-advances clauses. See \textit{1 Gilmore supra} note 13, §§ 10.1, 10.3 n.1, 11.6 & 11.7 n.1.

      \item \textit{Compare} \textit{Greene, supra} note 11, at 343 (suggesting that banks may have better success against Article 9 security interests if they acquire a common-law security interest rather than rely on their setoff rights, which frequently lose under § 9-201).

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guidance and concluded that a first-in-time rule apply.\footnote{Id. at 1242-44. Although based on Louisiana law, the decision appears firmly rooted in general common-law principles, and does not appear to tied to the civil-law tradition of the State. \textit{Cf.} Rauer, \textit{supra} note 33, at 250-51 (arguing that first-in-time principles should be a major consideration in such a priority dispute because they help minimize total credit costs).} However, whether other courts will follow this example is impossible to predict.

\section*{The Benefits of Expanding Article 9}

Bringing deposits accounts more fully within the Article 9 regime is good for the banking industry. Indeed, it was a bank group’s proposal which led to the repeal of the deposit account exclusion in Illinois.\footnote{Committee Hearing on Ill. H.B. 3436 (1992) (available on audio cassette). The only testimony regarding the bill was by Joseph Ambrose, attorney for the Community Bankers’ Association, who described the common-law rules regarding deposit accounts as “arcane” and noted that there is “considerable amount of confusion and litigation, especially with the IRS, as to whether or not a security interest in a deposit account exists and whether or not it’s perfected.”} This is no doubt in part because the banking industry would comprise the bulk of the lenders who take direct security interests in deposit accounts – even accounts maintained with other depositaries – and would thus be the ones to benefit by clear rules regarding such transactions. It is also because under current law a bank cannot rely on its setoff rights to assure payment of a debt owed by a depositor. All too often, courts conclude that either those setoff rights do not exist or they have been primed by some third party’s claim to the deposits.

\subsection*{Phantom Setoff Rights}

Setoff rights are subject to numerous common-law and statutory limitations.\footnote{An example of a statutory limitation is § 169 the Fair Credit Billing Act of 1974, which prohibits a bank from setting off a deposit account balance against a debt arising out of a revolving credit card plan, such as Visa or MasterCard. 15 U.S.C. § 1666h (1988). Notably, the Act does not prohibit a bank from obtaining and enforcing a security interest in the deposit accounts of a credit card customer, 12 C.F.R. § 226.12(d) (1993), although such a security interest must be expressly authorized in writing by the consumer, must be properly disclosed, and must be generally available to other creditors “to the same extent.” \textit{Official Staff Commentary, 12 C.F.R. Part 226, Supp. I, ¶ 12(d)(2) (1993).} The effect of this last requirement is somewhat unclear, since creditors cannot generally obtain a security interest in a deposit account exists and whether or not it’s perfected.”} Most of these limitations are based on sound policy and do not normally frustrate the reasonable expectations of the parties. For example, a person cannot normally effect setoff against an unmatured debt.\footnote{\textit{See, e.g.,} Frierson \textit{v. United Farm Agency, Inc.,} 868 F.2d 302, 313 (8th Cir. 1989); Credit Alliance Corp. \textit{v. National Bank,} 718 F. Supp. 954, 957 (N.D. Ga. 1989); In re Cabrillo, 101 B.R. 443, 447 (Bankr. E.D. Pa. 1989); In re Amco Products, Inc., 12 B.R. 758, 764 (Bankr. W.D. Mo. 1982) (citing earlier authority); Amaya \textit{v. Santistevan,} 835 P.2d 856, 860-61 (N.M. App. 1992). \textit{See also} Wilkinson, \textit{supra} note 26, at 250 & n.5 (noting some exceptions); Sepinuck, \textit{supra} note 16, at 67 n.67 (citing additional authorities). \textit{Cf.} Carpenter S. Cal. Admin. Corp. \textit{v. Manufacturers Nat’l Bank,} 910 F.2d 1339 (6th Cir. 1990) (after receiving writ of garnishment, bank could accelerate debt and effect setoff against deposits); First Bank \textit{v. Samocki Bros. Trucking Co.,} 509 N.E.2d 187, 199-99 n.7 (Ind. App. 1987) (suggesting that the maturity requirement may not exist in Indiana). There is an exception normally if the debtor is insolvent. \textit{See} Wilkinson, \textit{supra} note 26, at 250;}
contrary rule would essentially permit a person to use setoff rights to enforce payment on a debt not yet due, and thus unilaterally alter the terms of the underlying contract. The similar prohibition applies to both contingent and unliquidated debts. 89

A more significant limitation on setoff rights exists, however, and it can be quite problematic. Known as the “mutuality” requirement, it restricts setoff to only those sets of debts that are between the same parties acting in the same capacity. In its simplest form, this requirement merely dictates that the debtor and creditor on one debt be the creditor and debtor on the other debt. 90 In this general sense, the mutuality requirement makes perfect sense. Moreover, in many if not most circumstances the doctrine is fairly easy to apply. 91 However, when applied to joint deposit accounts and “special” deposits, the requirement has caused widespread confusion, conflicting decisions, and unwarranted results.

Courts have reached varying results when a depositary seeks to setoff deposits in a joint account against the obligation of only one of the depositors. Some courts deny setoff under such circumstances unless the deposit contract provides otherwise, others permit it without limitation, and still others allow it only to the extent the debtor was the source of the deposits. 92 To add to the uncertainty, most jurisdictions have not yet ruled on the issue. Thus, most depositaries cannot reasonably rely on their setoff rights against joint deposits.

More importantly, particularly for the deposits of a business, some courts have shown an unfortunate eagerness to classify deposits as “special,” so as to make mutuality lacking and setoff unavailable. 93 Under this doctrine, courts occasionally use the flimsiest of reasons for concluding that mutuality is lacking: stating that the deposits “belong” to some third party even though that party neither sought nor obtained an escrow arrangement or any restrictions on withdrawal. 94 For example, courts have denied setoff if the depositor informs a bank official that a deposit will be used

89 Sepinuck, supra note 16, at 67 n.68.
90 See, e.g., CLARK, supra note 35, ¶ 14.06; Clark, supra note 34, at 214-18. See also 11 U.S.C. § 553(a) (1988) (requiring that debts be “mutual” for setoff rights to be recognized in bankruptcy proceedings).
91 See, e.g., Wakefield v. First Bank Nat’l Ass’n, 577 N.E.2d 434 (Ohio App. 1991) (not permitting bank to set corporate debt off against shareholder’s personal checking account).
92 Sepinuck, supra note 16, at 70-71. See also Graham v. Bank of Leakesville, 556 So. 2d 1079 (Miss. 1990) (allowing bank to set off funds in joint account); Greenwood v. Bank of Illmo, 782 S.W.2d 783 (Mo. App. 1989) (denying bank right to set off amounts owed to it by a mother against its obligation on a CD owned jointly by the mother and her children, since the children had provided the funds needed to purchase the CD). In some states, statutes address this issue. E.g., Colo. Rev. Stat. § 11-6-105 (Supp. 1993) (allowing banks to set off joint deposits to collect a debt owed to the bank by a joint depositor).
There is little dispute that when the joint parties are debtors, not creditors, of the bank, the bank may effect setoff against either debtor’s individual deposit account. E.g., Rosa v. Colonial Bank, 542 A.2d 1112 (Conn. 1988).
93 Wilkinson, supra note 26, at 251-54; Sepinuck, supra note 16, at 71-75.
94 Blanchette v. Keith County Bank & Trust Co., 437 N.W.2d 488, 494 (Neb. 1989) (“a bank may not set off funds in a depositor’s account in payment of the depositor’s indebtedness to the bank when the bank knows or should know that the funds being set off belong to another”).
to pay off unspecified creditors. Some have reached a similar result if the bank simply knows that the depositor is a general contractor whose large deposits normally include payment for work, part of which is owing to subcontractors. Even the mere designation of a deposit account as a “payroll account” may be sufficient to render the deposits special and thus unavailable for setoff. Although not all courts are so hostile to setoff rights, and some public policy does support the courts which are, the lack of certainty – coupled with the occasional potential for punitive damages if the bank is deemed to have acted improperly – make reliance on setoff unattractive.

The Stacked Cards of Priority

The setoff rights of depositary institutions have proven woefully inadequate to protect depositary from the rights of some competing claimant to the deposits. Although a bank’s setoff rights typically defeat the claim of garnishor or other judgment creditor seeking to attach or execute upon a depositor’s account, they are typically lose to the rights of an Article 9 secured party.

Courts generally follow one of three approaches when dealing with a dispute between a bank claiming setoff rights and a secured party claiming an interest in the deposits as proceeds of other collateral. No matter which approach they use, however, the setoff claimant almost always loses. Some courts conclude that despite the section 9-104(i) exclusion of setoff rights from the

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95 See, e.g., Rainsville Bank v. Willingham, 485 So. 2d 319 (Ala. 1986). See also First City Nat’l Bank v. Long-Lewis Hardware Co., 363 So. 2d 770 (Ala. 1978) (deposits intended for automobile purchase were “special” and not available for setoff; equitable estoppel, although not argued, might have justified the result).


97 In re Saugus Gen. Hosp., 7 B.R. 347 (Bankr. D. Mass. 1980), aff’d, 698 F.2d 42 (1st Cir. 1983). Contra In re Goodson Steel Corp., 488 F.2d 776 (5th Cir. 1974); Ribaudo v. Citizens Nat’l Bank, 261 F.2d 929 (5th Cir. 1958); In re Tonyan Constr. Co., 28 B.R. at 727. See also In re Nat Warren Contracting Co., 905 F.2d 716 (4th Cir. 1990) (suggesting a payroll account might be a special deposit, but concluding that any “special” nature of the deposits is lost when they are commingled with other funds).

98 Businesses do need access to the payment system, and it would be undesirable if their reliance on that system were frequently frustrated by setoff rights. This concern is particularly acute for businesses, such as general contractors and jobbers, who frequently deposit a check prior to remitting all or a substantial portion of its face amount to someone else involved in the transaction giving rise to that payment. See Coffee County Bank v. Mitchum, 1993 WL 521187 (Ala. App. 1993) (involving a deposit of the proceeds from a consignment sale). Transaction costs would increase significantly if subcontractors and sellers had to obtain escrow agreements or tangible security for every transaction.


101 See generally Wilkinson, supra note 26, at 254-57; Rauer, supra note 33, at 249-50.

102 See Chrysler Credit Corp v. Whitney Nat’l Bank, 798 F. Supp. 1234, 1243 (E.D. La. 1992) (“courts have nearly unanimously found that the secured creditor’s interest in proceeds has priority over the bank’s right of setoff”); Coenen, supra note 20, at 1161 (the theme of the cases is that “courts almost always
scope of Article 9, the Code still governs the priority issue. Relying on section 9-201, these courts invariably rule for the secured party, although strong arguments can be made that the proper analysis would require application of section 9-318 and would generate results more favorable to the bank.

Those courts that conclude that the common law governs this issue, apply one of two rules: the so called “legal” rule or the “equitable” rule. Under the legal rule, the setoff claimant loses subordinate the professional financer” exercising setoff rights to an Article 9 secured party “and are willing to bend the Code’s text to achieve that result”); Harrell, supra note 16, at 161 (“a right of setoff is likely to be subordinate to virtually any prior third-party claim”); CLARK, supra note 20, ¶ 3.11, at 3-128 (“courts almost always give priority to the Article 9 claimant”); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 21-8, at 954 (3d ed. 1988) (“Generally, however, the holder of a perfected security interest prevails over the party claiming the right to set-off”).

Other courts have implied that Article 9 governs the issue. See, e.g., Sterling Nat'l Bank & Trust Co. v. Southwire Co., 713 F.2d 684 (11th Cir. 1983); Farns Assoc., Inc. v. South Side Bank, 417 N.E.2d 1091 (Okla. 1980).

For criticisms of these cases, see the authorities cited supra note 82.


if any time before effecting setoff it knew or had reason to know of the third party’s interest in the deposits. Quite clearly, this is a difficult standard for banks to satisfy, and is not nearly as generous as section 9-318(1). The equitable rule is even worse for the setoff claimant. Under that rule the setoff claimant without knowledge or notice of the competing claim will still lose unless it acted in detrimental reliance on the deposits, such as by extending credit or delaying enforcement.

If a bank had a security interest in a customer’s deposits, it might well stand a better chance of defeating the rights of another secured party. It would thus be better able to avoid some of the remarkably unfair results that courts have reached. It would certainly fare better against a bankruptcy trustee and the Internal Revenue Service.

The Bankruptcy Code generally accords favorable treatment to setoff rights. However, under section 553(b) of the Bankruptcy Code, a creditor who effects setoff within the 90 days before the petition for bankruptcy relief is filed may have to disgorge all or a portion of the amount set off. This rule essentially prevents a creditor from improving its position vis-à-vis the bankruptcy estate during the three months preceding the bankruptcy filing, and is roughly analogous to the

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Compare Rauer, supra note 33, at 239 n.17 (“[p]aradoxically, if the outcome of the three-party dispute is that the set-off claim loses to the third party creditor, there is no longer any mutuality – and, therefore, no valid set-off right”).

106 This would depend to some extent on the priority rules adopted. Neither the Subcommittee nor the Study Committee could reach a consensus on the appropriate priority rule for competing security interests, see Subcommittee Report § 7(b), at 24-27; Study Committee Report at 70 & 71, and thus, not surprisingly, the Drafting Committee too is having some difficulty resolving the issue. See supra note 39.

Note, although the Study Committee recommended that the depositary’s setoff rights should have priority over Article 9 security interests, Study Committee Report at 70, it is unclear how much amendments to Article 9 can do to clean up the common law of setoff. If courts are ready to conclude that the third party’s interest destroys mutuality needed for setoff rights to exist, see supra note 105, amendments to Article 9 may be inadequate to halt that tendency.

107 See, e.g., Republican Valley Bank v. Security State Bank, 426 N.W.2d 529 (Neb. 1988) (giving the pledgee of a CD priority over the issuing bank’s setoff rights because the pledgee gave notice of its interest – although after setoff rights accrued – before the bank effected setoff). This result violates the first-in-time principle embodied in the common-law doctrine nemo dat non quod habet (one cannot give what one does not have). Compare Restatement (Second) of Contracts § 336(2) (1981) (“The right of an assignee is subject to any defense or claim of the obligor which accrues before the obligor receives notification of the assignment”); U.C.C. § 9-318(1)(b) (rights of an assignee are subject to defenses and claims of the account debtor accruing before account debtor receives notification of assignment) (technically not applicable in the cited case because the CD qualified as an instrument, rather than as a general intangible, and thus there was no “account debtor” under § 9-105(1)(a)). But see Harrell, supra note 16, at 157 & n.20 (suggesting that the result is proper because setoff rights do not amount to a lien or other interest in the deposit account, but apparently overlooking the fact that the depositary actually owns the deposits and has only an unsecured obligation to repay them to the debtor).


However, the one-year period for insiders in § 547(b)(4)(B) apparently does not apply to setoff situations, and this may immunize a setoff claimant from a Deprizio problem. See In re Pineview Care Center, Inc., 152 B.R. 703 (D.N.J. 1993). Smith v. Mark Twain Nat’l Bank, 805 F.2d 278, 290-91 (8th Cir. 1986); In re 4-S Corp., 69 B.R. 499, 501 (Bankr. W.D. Mo. 1987) (both ruling that the limits in § 553 do not apply if the depositary is enforcing a consensual security interest). See also In re Madcat Two, Inc., 127 B.R. 206, 211-12 (Bankr. E.D. Ark. 1991) (apparently adopting this distinction). But see In re Riggsby, 34 B.R. 440, 441 (Bankr. E.D. Tenn. 1983) (equating depositary’s security interest in a deposit account it maintains with setoff rights).

Banks also frequently have priority disputes with the IRS over funds on deposit. The Internal Revenue Code grants the IRS a lien on all property rights of a delinquent taxpayer. Thus, the IRS has a lien on delinquent taxpayers’ deposit accounts. Although a federal tax lien will not prime a previously perfected security interest, courts have almost uniformly held that it defeats a bank’s unconsummated setoff rights. The rationale for this varies, but is typically based on either the

10 However, the one-year period for insiders in § 547(b)(4)(B) apparently does not apply to setoff situations, and this may immunize a setoff claimant from a Deprizio problem. See In re Pineview Care Center, Inc., 152 B.R. 703 (D.N.J. 1993).


12 Smith v. Mark Twain Nat’l Bank, 805 F.2d at 291.

13 Prepetition enforcement of a security interest is not normally a preference, since it typically does not enable the creditor to receive more than the creditor would have in bankruptcy. Cf. 11 U.S.C. § 547(b)(5) (1988).

14 In one respect, having a security interest in addition to setoff rights could conceivably be detrimental to the bank. Consider the case of a debtor who, within the 90 days preceding the bankruptcy filing, makes additional deposits to its deposit account. A bank with no security interest would have its setoff rights enhanced by these additional deposits, and yet would normally be allowed to retain that benefit since the additional deposits would rarely have been made for the purpose of obtaining or enhancing setoff rights. See 11 U.S.C. § 553(a)(3) (1988). A bank that did have a security interest in the deposit account, and whose rights were therefore subject to preference attack, might well find those prepetition deposits to be avoidable. See 11 U.S.C. § 547(b) (1988). They certainly operate to increase the bank’s security, and that would normally be an avoidable preference for an undersecured creditor. The bank could argue that it gave new value—the concomitant debt to the depositor—but that argument is weak at best. See 11 U.S.C. § 547(c)(1) (1988).

15 Of course, few debtors actually increase their deposits shortly before filing for bankruptcy protection, so this potential drawback to taking a security interest may be more academic than real.

16 I.R.C. § 6321. This lien arises upon assessment. I.R.C. § 6322.

17 See I.R.C. § 6323(a): “The lien imposed by section 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic’s lienor, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary.”
The Overstated Risks of Expanding Article 9

Enforcement Procedures & The Payment System

One week before the Subcommittee issued its final report, and with the footprints of the Federal Reserve Bank of New York all over its back, the Banking Law Committee of the Association of the Bar of the City of New York issued some written comments on the Subcommittee’s April 30th draft.121 Although the Banking Committee acknowledged that it had not reviewed the report in depth or discussed the report and its recommendations in detail,122 it nevertheless criticized the entire project and reasserted the banking industry’s claim that deposit accounts are somehow “special.”123

118 See I.R.C. § 6323(h)(1) (defining “security interest”). See also United States v. Sterling Nat’l Bank & Trust Co., 360 F. Supp. 917, 923-24 (S.D.N.Y. 1973) (ruling that contractual setoff rights are not a “security interest” – largely because they are not governed by Article 9). Compare Peoples Nat’l Bank v. United States, 777 F.2d at 461 (concluding that contractual rights were not a security interest, but acknowledging that the term is not limited to Article 9 interests).

119 Compare United States v. Bell Credit Union, 860 F.2d 365, 371-72 (10th Cir. 1988) (bank’s rights not choate because lack of withdrawal restrictions allowed amount of property subject to those rights to vary); United States v. Sterling Nat’l Bank & Trust Co., 360 F. Supp. at 924 (bank’s rights not choate until setoff exercised and the amount applied against the loan thus determined) with Jefferson Bank & Trust Co. v. United States, 684 F. Supp. 1542, 1547 (D. Colo. 1988); United States v. Harris, 249 F. Supp. 221, 224 (W.D. La. 1966) (both concluding that bank’s lien was choate despite the fact that the deposit balance could vary).

The “choateness” requirement was a common-law creation that predated enactment of the Tax Lien Act of 1966, which added § 6323(a) & (h)(1) to the Internal Revenue Code. There is significant disagreement both within and among the circuit courts whether this doctrine survives. See Jersey State Bank v. United States, 926 F.2d 621, 623-34 (7th Cir. 1991); Texas Commerce Bank v. United States, 896 F.2d 152, 161 n.8 (5th Cir. 1990); United States v. Bell Credit Union, 860 F.2d at 369 & 371.

120 See Jefferson State Bank & Trust Co. v. United States, 684 F. Supp. 1542 (D. Colo. 1988) (bank’s setoff rights ineffective against tax lien, but its common-law security interest has priority), aff’d, 894 F.2d 1241 (10th Cir. 1990); See also Greene, supra note 11, at 346 (perfected common-law security interests have priority over a federal tax lien); Trust Co. v. United States, 735 F.2d 447 (11th Cir. 1984) (holding, after minimal analysis, that bank’s security interest was entitled to priority); Committee Hearing, supra note 86 (indicating that disputes with the IRS were a principal basis for the banking community’s desire to bring deposit accounts within Article 9).


122 Id. at 1.

123 Id. at 2. A detailed rebuttal of the Banking Committee’s specific comments is unnecessary – in part because the whole article serves as a rebuttal and in part because of the ridiculousness of some of the
A few weeks later, counsel for the New York Fed appealed to the ABA Subcommittee on Commercial Paper, Bank Deposits, Collections and Payment Systems to intervene in the revision process.\textsuperscript{124}

The representatives of the New York Fed are quite proper in their concern with protecting the payment system. Yet in two years – with two of its attorneys serving on the Subcommittee – they were never able to offer one credible explanation of how the Subcommittee’s recommendations could “screw up” the payment system. Indeed, the current law presents a much greater danger to the payment system than do the proposals for change; the proposals would add needed clarity and safeguards to the current rules.

\section*{The Current Law}

When the party enforcing its security interest in a deposit account is the depositary institution itself, there is not much confusion about what must or may be done. The depositary simply debits the deposit account, much as it would in an effort to effect its setoff rights. Although the timing of this action may affect a few priority disputes,\textsuperscript{125} there is little problem in knowing what to do. Of course, that does not mean that there is no uncertainty about what to do. In fact, one question is arguably most serious when the secured party is the depositary.

Banking Committee’s claims. For example, in what must be regarded as an attempt to be amusing, the Banking Committee objected to the Subcommittee’s recommendation that depositaries should not be able to prevent their depositors from collateralizing deposit accounts. The Banking Committee stated:

\begin{quote}
Ironically, Section 5 of the Report states that its proposals are designed to further one of the underlying purposes of the UCC, which is to “facilitate commercial transactions and freedom to contract.” Precluding depositary institutions from prohibiting or limiting the grant of a security interest in a transaction account would deny depositary institutions freedom of contact and inhibit commercial transactions.
\end{quote}

\textit{Id.} at 4. This argument, of course, turns the policy underlying § 9-318(4) on its head. It essentially states that freedom of contract requires that people be free to prevent others from contracting. While in theory there may be something to this argument when parties are truly of equal bargaining strength, deposit account agreements often closely resemble contracts of adhesion. \textit{Cf.} Perdue v. Crocker Nat’l Bank, 702 P.2d 503 (Cal. 1985). In short, under the rubric of “freedom of contract,” the Banking Committee seeks to give the banking industry the power – which it would quickly exercise and has already exercised in Louisiana – to prevent all but the largest of depositors from being free to collateralize their deposits. \textit{See CLARK, supra} note 35, ¶ 14.14, at S14-7 (if permitted, “banks would include anti-assignment provisions as boilerplate in their deposit agreements, with the result that deposit accounts could never be taken as collateral”).

\textsuperscript{124} Letter from Thomas C. Baxter, Jr., Counsel, Federal Reserve Bank of New York, to Members of the Subcommittee on Commercial Paper, Bank Deposits, Collections and Payment Systems (July 17, 1992) (on file with the author).

\textsuperscript{125} For example, the depositary’s liability on a check drawn on the deposit account will depend on whether it forecloses before it has finally paid the item. \textit{See U.C.C.} § 4-215. \textit{See also} Lockhart Sav. & Loan Ass’n v. Republicbank Austin, 720 S.W.2d 193 (Tex. Civ. App. 1986) (finality of payment affected by the applicable clearinghouse rules); Sepinuck, \textit{supra} note 16, at 77 & n.100 (collecting cases on priority of bank with setoff rights vs. check payee).

The priority of the depositary’s setoff rights – particularly over a tax lien or a bankruptcy trustee – are often affected by the time when the depositary attempts to assert such rights. It is unlikely that the depositary’s rights under a security interest would be similarly affected. \textit{See supra} notes 109-120 and accompanying text.
Nothing in the Official Text of Article 9, the commentary to it, or the judicial decisions interpreting it provides adequate guidance on whether and when the secured party or the depositary must notify the debtor of its foreclosure on a deposit account. Indeed, there is no certainty about what notice is required even when a traditional accounts financer forecloses on the collateral by instructing the account debtors to make payment to it. Most authorities have rejected the need for advance notice, but have said little or nothing about whether notice after collection efforts begin is required as part of the obligation to act in a commercially reasonable manner. When collecting on a deposit account, the need for notice is particularly acute. After all, absent such notice the debtor may continue to write checks drawn on the deposit account in the belief that such checks would clear. When the checks are then dishonored, the debtor’s financial credibility may be irreparably damaged. For this reason, the Subcommittee recommended that prompt notice after foreclosure be required.

When the party enforcing its security interest in a deposit account is not the depositary, matters are much more problematic. There is simply no clear guidance on how a nondepositary creditor is to enforce a security interest in a deposit account containing proceeds of other collateral. For example, must the secured party provide documentation to support its right to the account? If so, what documentation is necessary?

More importantly, the depositary has no clear guidance on what it must do and how quickly it must do it. For example, if the secured party does provide adequate documentation, must the

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126 Cf. In re 4-S Corp., 69 B.R. 499, 501-02 (Bankr. W.D. Mo. 1987) (ruling that no advance notice is needed under § 9-504 for depositary to foreclose on Article 9 security interest); Gillman v. Chase Manhattan Bank, 534 N.E.2d 824, 831-32 (N.Y. 1988) (holding no advance notice needed for depositary foreclosing on common-law security interest to be in good faith).

127 See Western Decor & Furnishings Indus., Inc. v. Bank of Am., 91 Cal. App. 3d 293, 303-05, 154 Cal. Rptr. 287, 292-93 (1979) (holding that no advance notice is needed under § 9-502(2) and stating that the creditor “was under no duty to keep [the debtor] informed of its collection efforts”); Cullen Frost Bank v. Dallas Sportswear Co., 730 S.W.2d 668 (Tex. 1987) (reasoning and holding that advance notice of intent to collect through the debtor is not required under § 9-502(1) after concluding that advance notice of direct collection is not required under § 9-502(2)). See also Cornelius J. Chapman, Jr., Collection from Account Debtors: The Case for Notice to the Debtor Revisited, 17 UCC L. J. 3 (1984), and Arnold G. Regardie, Accounts Receivable Financing: The Case for Notice to the Borrower on Default, 16 UCC L. J. 3 (1983) (debating the need for advance notice); David Brown, Default and Enforcement under Article 9, in BASIC UCC SKILLS 1987: ARTICLE 5 AND ARTICLE 9, at 423-24 (PLI Comm. Law & Prac. Course Handbook Series No. 433, 1987) (stating that no advance notice is required but suggesting that to be commercially reasonable the secured party should maintain “close contact with [the] debtor”). Compare Sepinuck, supra note 16, at 64-66 (discussing the need for notice after effecting setoff); Boyle v. American Sec. Bank, 531 A.2d 1258 (D.C. App. 1987) (holding that no advance notice of setoff is necessary); Elizabeth C. Yen, Banking Decisions – Disclosure of the Right of Setoff for Truth in Lending Purposes, 105 BANKING L.J. 243 (1988) (concluding that banks need not disclose their right of setoff); Mancuso v. United Bank, 796 P.2d 7 (Colo. App. 1990) (ruling that a bank is not obligated to inform a joint depositor of its right of setoff for debts owed by the co-depositor), aff’d in part & rev’d in part on other grounds, 818 P.2d 732 (Colo. 1991).

128 Subcommittee Report § 8(c), at 33-34. Presumably also for this reason Indiana requires that a depositary institution that receives notice of an adverse claim and places a hold on the depositor’s account must notify the depositor of that action within one working day. Ind. Code Ann. § 28-9-4-2(a)(3) & (4) (Burns 1993).


130 Cf. U.C.C. § 9-318.
It is somewhat surprising that these questions have not prompted extensive litigation, although disputes about them have arisen. See Aeronautics & Astronautics Services v. First Palm Beach Int’l Bank, 471 So. 2d 188 (Fla. App. 1985) (involving a priority dispute between a check payee and a secured party claiming the deposit account as proceeds); Anderson, Clayton & Co. v. First Am. Bank, 614 P.2d 1091, 1095 (Okla. 1980) (ruling that funds paid outside the ordinary course of business from a deposit account containing collateralized proceeds were still covered by the security interest).

Other issues arguably concerning the payment system that can currently arise deal with when a payment from or a debit to a deposit account is sufficiently within the ordinary course of the depositor’s business to allow the recipient to take free of a security interest in the funds claimed as proceeds. This issue is particularly troublesome when the debit or payment made is in favor of the depositary itself. See, e.g., Orix Credit Alliance, Inc. v. Sovran Bank, 4 F.3d 1262 (4th Cir. 1993) (debit made in ordinary course; depositary took free of security interest); Barber-Greene Co. v. National Bank, 816 F.2d 1267 (8th Cir. 1987) (debit not made in ordinary course); In re Halmar Distributors, Inc., 116 B.R. 328 (Bankr. D. Mass. 1990) (debit made in ordinary course), rev’d on other grounds, 968 F.2d 121 (1st Cir. 1992); Anderson, Clayton & Co. v. First Am. Bank, 614 P.2d 1091 (Okla. 1980) (debit made in ordinary course).

These statutes do not shield a depositary that fails to diligently comply with a proper order. See, e.g., First Bank v. Samocki Bros. Trucking Co., 509 N.E.2d 187 (Ind. App. 1987). Moreover, a depositary that refuses to recognize an adverse claim unaccompanied by the requisite bond or court order may not then use its rights and duties with respect to transactional accounts are even more unclear. May it make final payment on items presented before receipt of the secured creditor’s demand? May it pay items presented after? If it improperly pays an item, will it – or the payee – be liable to the secured party? Must it freeze the account? Will it be liable to the debtor if it does? In short, the depositary cannot be certain that it will be immune from liability if it pays the secured party or what proof it must require either of the secured party’s interest or of default. Alternatively, it cannot be certain that it will be immune from liability if allows the deposit account to be depleted after refusing to pay the secured party without a court order.

Article 9 addresses none of these questions, either for creditors seeking to collect proceeds covered into a deposit account or for creditors seeking to enforce a security interest in a deposit account as original collateral in the few jurisdictions where Article 9 governs such transactions.131

Although other statutes may speak to these issues, they provide at best vague and non-uniform guidance. For example, two-thirds of the states have statutes authorizing or instructing a depositary not to respond to an adverse claim to a deposit account unless accompanied by a restraining order or injunction.132 However, many of these statutes have an exception if the adverse

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131 It is somewhat surprising that these questions have not prompted extensive litigation, although disputes about them have arisen. See Aeronautics & Astronautics Services v. First Palm Beach Int’l Bank, 471 So. 2d 188 (Fla. App. 1985) (involving a priority dispute between a check payee and a secured party claiming the deposit account as proceeds); Anderson, Clayton & Co. v. First Am. Bank, 614 P.2d 1091, 1095 (Okla. 1980) (ruling that funds paid outside the ordinary course of business from a deposit account containing collateralized proceeds were still covered by the security interest).

claimant is the beneficial owner of the deposit account for whom the depositor is a fiduciary in the process of misappropriating funds.\textsuperscript{133} This exception typically provides that the statutory provision does not apply:

in any instance where the person to whose credit the deposit stands is a fiduciary for such adverse claimant and the facts constituting such relationship, as well as the facts showing reasonable cause of belief on the part of the said claimant that the said fiduciary is about to misappropriate said deposit, are made to appear by the affidavit of such claimant.\textsuperscript{134}

It remains unclear whether a secured party can take advantage of this exception. A debtor in default arguably controls the collateral in constructive trust for the secured party. Additionally, the security agreement itself might purport to make the debtor a fiduciary for the secured party. On the other hand, these exceptions may be designed to deal only with accounts labelled with the depositary as fiduciary accounts.\textsuperscript{135} Any other interpretation would tend to allow the exception to devour the rule. In any event, the lack of judicial guidance on this leaves the efficacy of these statutory efforts to protect depositaries and the payment system in doubt.\textsuperscript{136}

Thus, even if Article 9 were not broadened to cover security interests in deposit accounts as original collateral, amendment to clarify and standardize the process of enforcement would be necessary. Indeed, such efforts are critically necessary in those jurisdictions that lack an adverse


Most of these statutes are based on a model recommended by the American Bankers Association. C.C. Marvel, Annotation, \textit{Construction, Application, and Effect of Statute Relating to Notice to Bank of Adverse Claim to Deposit}, 2 A.L.R.2d 1116, 1116-17 (1958).


\textsuperscript{135} Compare Colo. Rev. Stat. § 11-6-107 (1987), requiring that the fiduciary be “designated as such by words indicating the deposit . . . is . . . held for the benefit of the adverse claimant.” Presumably this designation must be in the deposit contract with the depositary.

\textsuperscript{136} This is apparently why Pennsylvania chose to delete the fiduciary exception from its statute:

The prior Code made an exception to the requirement of a bond or restraining order where the adverse claimant provided an affidavit that the depositor was a fiduciary and that the claimant had “reasonable cause of belief” that the fiduciary was about to misappropriate the deposit. This exception was susceptible to abuse particularly because of the ease with which a fiduciary relationship could be claimed. The exception is eliminated by the omission from this section 606 of any distinction between a fiduciary and any other customer.

claim statute. Since enforcement issues are the ones that generate the most controversy and disagreement, satisfactory resolution of them leaves little reason not to extend the scope of Article 9.

**The Proposals for Change**

The current proposal before the Drafting Committee would authorize a depositary that has not already agreed otherwise to refuse to respond to a non-judicial demand by a secured party. In essence then, a secured party that perfected by filing would have to get a court order to enforce its rights to the deposits. This is consistent with the approach taken in the adverse claim statutes and in the pending Article 8 revisions, but differs from the Subcommittee’s recommendation that the demand – if made properly – require the depositary to temporarily freeze the account.

There is much to be said for having the enforcement procedures for security interest in brokerage accounts and deposit accounts be the same, since distinguishing between the two is already difficult and is likely to become more so. Moreover, the New York Fed is apparently willing to accept such an enforcement process, and if removal of its opposition to the proposed changes is politically necessary for the amendments to have a chance of success, then the Subcommittee’s recommendation should be abandoned.

On the other hand, the Subcommittee’s recommendation would alleviate the problems and confusion with existing law no less than would the current Drafting Committee proposal. Moreover, a likely consequence of the Drafting Committee’s so-called “get lost” rule, is that during the time when the secured party is seeking a court order, the debtor will deplete the deposit account. This would reduce – perhaps greatly reduce – the value of the deposit account as collateral, and would be inconsistent with the rules generally applicable to accounts receivable and general intangibles.

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137 Note, these jurisdictions include Hawaii and Illinois, both of which permit Article 9 security interests to cover deposit accounts as original collateral.

138 See Study Committee Report at 71 (disagreeing with the Subcommittee’s recommendations on enforcement).

139 Drafting Committee Proposal § 9-318A, at 17-18.

140 Presumably, it could also induce the bank to freeze the deposit account by offering to indemnify the bank from any resulting liability. The bank need not agree to this, however.

141 See ALI, supra note 18, §§ 8-207, 8-401, 8-404, and accompanying commentary.

142 Subcommittee Report § 8(b), at 31-33.

143 See cases cited supra note 17.

144 An account debtor who pays the debtor after receiving a proper direction from the secured party to make payment directly to it, remains liable to the secured party. See § 9-318(3) & comment 3; Commonwealth Fin. Corp. v. DeWalt, 555 N.E.2d 1141 (Ill. App. 1990); Bank of Commerce v. Intermountain Gas Co., 523 P.2d 1375 (Idaho 1974). See also supra note 35 (noting that a deposit account is a type of general intangible).
More to the point, such a rule is unnecessary. There is really no danger to the payment system – on either an operational or systemic level – from the Subcommittee’s proposal. First, from an operational standpoint, banks are more than adequately prepared to deal with demands from someone other than the depositor. No one disputes that banks do and should have to respond to a court order, and yet there is no reason to think that authentication of such an order – if banks actually do that now – is any easier than authentication of a secured party’s proper demand. There is nothing special about a judge’s signature. Indeed, banks already have a duty to respond to certain non-judicial notices: the state adverse claim statutes in no way shield depositories from their duty under federal law to deal with an administrative tax levy or with a notice of a bankruptcy filing.

Second, and more importantly, freezing a bank account cannot cause the cascading and systemic failure of transactions that can occur in a securities or commodities exchange. This is particularly true since both the Subcommittee’s recommendation and the Drafting Committee’s current proposal would fully protect a bank’s extension of intra-day credit from the reach of any

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145 Whether the Subcommittee’s recommendation adequately protects depositors is another issue. It seems doubtful that the possibility of fraudulent enforcement efforts – such as by people who have no security interest at all – is significantly higher with bank accounts than with accounts receivable and general intangibles. On the other hand, people inclined to fraudulent activity may have easier access to information about a person’s bank account than about a person’s accounts receivable.

146 See I.R.C. § 6332(a). Indeed, failure to properly respond to this makes the bank liable not only for the resulting lost tax revenue, but also for a penalty equal to 50% of that loss. I.R.C. § 6332(c). See also United States v. Bell Credit Union, 860 F.2d 365 (10th Cir. 1988); United States v. Third Nat’l Bank, 589 F. Supp. 155 (M.D. Tenn. 1984); United States v. Sterling Nat’l Bank, 360 F. Supp. 917 (S.D.N.Y. 1973) (all imposing the penalty).


The more interesting question for the purposes of this discussion is under what circumstances may a bank be required to freeze the account. See Clark, supra note 35, ¶ 14.09, at S14-3. If the deposits represent cash collateral, allowing the debtor access, particularly in a Chapter 7 proceeding, may be improper. Cf. In re Pimental, 142 B.R. 26 (Bankr. D.R.I. 1992) (permitting a freeze in such circumstances; the same court concluded in In re Flynn that a freeze violates the stay).
secured party,\textsuperscript{148} and would maintain the exclusion from Article 9 for deposit accounts of one bank maintained with another.\textsuperscript{149}

Of course, caution and conservatism are dictated in this matter, particularly since future events and conditions are difficult to predict. Still, it seems likely that any possible interference with the payment system will only decrease over time, as we move toward a paperless, instantaneous-debit society. Accordingly, renewed consideration should be given to the Subcommittee’s recommendation, which was, after all, formed with significant input from bank counsel.

**Consumer Protection**

Most people involved in the Article 9 revision process agree that consumers must be adequately protected, and that any changes made should not inure unduly to their detriment. Although some may disagree over whether those protections should be included within Article 9 itself or left to non-uniform state consumer protection statutes, virtually no one argues – at least not publicly – that protecting consumers from overzealous or fraudulent creditor activity is inappropriate.

Given this general consensus, it is appropriate to review the concerns that consumer advocates have raised. While not all of the expressed concerns relate solely to consumers,\textsuperscript{150} four principal objections focusing on consumers continue to surface. First, advocates have argued that the potential for creditor abuse will be greatly augmented.\textsuperscript{151} Second, that consumers will not benefit from the proposed change, but will merely suffer at the expense of creditors.\textsuperscript{152} Third, that there is simply no need for security interests in deposit accounts in the consumer context.\textsuperscript{153} Finally, that the proposed changes might interfere – advertently or inadvertently – with consumers’ ability to utilize and rely on various state and federal laws that exempt certain needed assets from the reach of creditors.\textsuperscript{154} All of these concerns have some merit and warrant discussion.

\textsuperscript{148} Indeed, all of the bank’s rights against a depositor arising from the operation of the deposit account would take priority. See Drafting Committee Proposal § 9-312A, at 13-14 (only alternative options 3A-4B were under serious consideration at the Drafting Committee’s meeting in Boston); Subcommittee Report § 7(a) & (b), at 22-27 & 44-47. See also Study Committee Report at 70 (recommending the same).

\textsuperscript{149} See Drafting Committee Proposal § 9-104, at 3; Subcommittee Report § 4(g), at 12-13 & 38.

\textsuperscript{150} Some expressed concerns relate to the method of enforcing such a security interest. Letter from Gail Hillebrand, supra note 4, at 7-8. However, the consumer nature of a transaction has little direct relationship to these concerns. An enforcement mechanism that adequately deals with the legitimate concerns of both business debtors and the payment system will adequately deal with consumer debtors too.

\textsuperscript{151} Letter from Gail Hillebrand, Litigation Counsel, Consumers Union, to William Burke, Chair, Article 9 Drafting Committee 14 (Sept. 22, 1993) (on file with the author).

\textsuperscript{152} Id.

\textsuperscript{153} Id.

\textsuperscript{154} Id. at 6-7.
CREDITOR ABUSE

One notable consumer advocate has argued that a security interest in a consumer’s deposit account could be created without the depositor’s knowledge or consent through use of a pre-printed form by a creditor. She explains such contracts often contain small type that is dense and difficult to read. Moreover, she argues, those consumers who do read these forms often do not understand them and those who understand may lack the bargaining power to change them.\footnote{Letter from Gail Hillebrand, supra note 151, at 14.}

While truth-in-lending rules may provide some protection,\footnote{See 15 U.S.C. § 1637(a)(6) (1988); 12 C.F.R. § 226.6(c) (1993) (both dealing with open-end credit; 15 U.S.C. § 1638(a)(9) (1988); 12 C.F.R. § 226.18(m) (1993) (both dealing with closed-end credit). \textit{See also} 12 C.F.R. Part 226, Supp I, ¶ 12(d)(2) (1993) (suggesting that security interests granted in standardized forms would not be permissible); In re Clark, 161 B.R. 290 (Bankr. N.D. Fla. 1993) (denying setoff of deposit account for credit card debts because alleged security interest was not acquired properly under the rules).} it is difficult to contest this observation generally. Nevertheless, the observation is one that seems to have little to do specifically with deposit accounts. Certainly creditor overreaching of this type – if in fact this be overreaching – can occur regardless of the type of collateral involved. This is not to say that this problem need not be addressed, merely that the solution should be broad enough to deal with the entire problem, and not just one symptom of it.

THE LACK OF BENEFIT TO CONSUMERS

Attacking the assumption that more collateral is always a good thing, a consumer advocate has suggested that consumers typically do not receive either more credit or a lower interest rate when they provide more collateral.\footnote{Letter from Gail Hillebrand, supra note 151, at 14.} Implicit in this statement is the suggestion that broadening the scope of Article 9 to cover security interests in deposit accounts as original collateral would therefore be unfair to consumers. Yet even accepting the argument that consumers would not benefit, it is a logical leap to the conclusion that reform would be undesirable.

It is not at all clear why it is unfair or inappropriate to change the law in a way that enhances a creditor’s ability to obtain repayment of lawful debts, particularly if the method provided is more quick and economically efficient than proceeding through the clogged judicial system. The stereotypical notion of creditors either as vengeful, greedy, and deceitful or as impersonal and uncaring, and therefore somehow undeserving of payment, is both inaccurate and unfair. We simply cannot classify all commercial parties in such general terms. Not all consumers are honest, industrious, and simple-minded victims. Nor are they all immoral and dishonest deadbeats.

The point is not that we need the law to distinguish between the two, but that the distinction is largely immaterial. By and large, a creditor’s motive in seeking payment and a debtor’s reason for not complying are not the critical inquiries. Borrowers have both a legal and moral obligation to repay. A change in the law that makes repayment more likely does not necessarily need to provide some counterbalancing benefit to the borrower in order to be fair. This does not mean that the applicable legal rules should always favor the creditor or that in balancing the competing interests the legal rules never misweigh the interests on one side. Merely that the merits of any change must be evaluated in reference to what that proper balance is and how close the current law comes to achieving it. It is simply inappropriate to claim that every change itself must be equally balanced...
among the competing interests. Consumer advocates need to make a better case before this criticism warrants further attention.

**THE LACK OF NEED**

The suggestion that there is no need for security interests in consumers’ deposit accounts is unfounded. Admittedly, the utility of security interests in consumers’ deposit accounts as original collateral is difficult to measure and there is no statistical evidence about how frequently such interests are desired and when they are critical to the extension of credit. Nevertheless, a fair number of reported cases have involved attempts – usually by the depositary – to take a common-law security interest in a deposit account in what might fairly be regarded as a consumer transaction.\(^\text{158}\) This suggests that at least in some instances such interests are desired.

On the other hand, it may be that this desire can be satisfied without Amending Article 9 to make deposit accounts available as original collateral in consumer transactions. Most of the cited cases involved transactions either for which the deposit account was not a critical piece of the collateral,\(^\text{159}\) or in which the depositor had or needed limited access to the deposits.\(^\text{160}\) The former obviously do not demonstrate a need for change and the latter could easily have proceeded either under a *Duncan Box* common-law approach or by reifying the deposits into an instrument which could then be pledged to the creditor as security. Such action would bring the transaction within the existing rules of Article 9 and avoid all the vagaries of the common law. In other words, while it may be necessary the ensure that business debtors have access to their deposit accounts offered as collateral,\(^\text{161}\) the type of secured transactions involving consumer debtors may not be encumbered by such practical concerns.\(^\text{162}\)

Assuming this be true, there would appear to be no significant drawback to carving out an exception to the proposed amendments for transactions in which the depositor is an individual and


\(^\text{159}\) See In re Laues, 90 B.R. 158.

\(^\text{160}\) See Trotter v. First Fed. Sav. & Loan Ass’n, 378 S.E.2d 267; Rowland v. American Fed. Sav. & Loan Ass’n, 523 S.W.2d 207; Walton v. Piqua State Bank, 466 P.2d 316.

\(^\text{161}\) See supra notes 78-80 and accompanying text, discussing the inadequacy of the common law on this matter.

\(^\text{162}\) Businesses may need ready access to their deposit accounts to keep maintain operations and a secured creditor may be willing to rely on the varying total confident that some average amount will likely be on hand if resort to the collateral is necessary. While consumers too need ready access to at least a portion of their deposits to pay their bills, creditors generally would not find a consumer’s transactional account to be reliable collateral. Since the creditor in such a consumer transaction will typically want to restrict the debtor’s access to the deposits, it is not too problematic or expensive to have the parties reify the deposits and then treat the transaction as a security interest in an instrument.
the credit is extended for personal, family, or household purposes.\textsuperscript{163} Of course, even if there no significant need for Article 9 security interests in consumers’ deposit accounts exists presently, future circumstances may make such transactions very desirable. Moreover, one might legitimately argue that protecting consumers by denying them freedom of contract is the least desirable form of protection. Although undeniably effective, it is invariably over-inclusive. Protection either through disclosure requirements – regarding both what must be disclosed and how it must be communicated – or through cooling-off periods is arguably a more appropriate response to the potential for abuse.

\section*{Protecting Personal Exemptions}

Numerous state and federal statutes protect individuals from creditors by exempting certain assets from attachment and execution. If the asset is a deposit account, courts typically interpret such statutes as preventing setoff as well.\textsuperscript{164} Indeed, statutes that do not expressly exempt funds, but which otherwise treat them as special, may be deemed to destroy the mutuality needed to effect setoff.\textsuperscript{165} Perhaps more importantly, several statutes protect various payments – such as social security distributions and unemployment compensation – that may ultimately be deposited into a deposit account.\textsuperscript{166} Indeed, the individual may have no practical way to realize upon these payments other than to negotiate them into a deposit account. In part for this reason, courts frequently interpret the applicable exemption statute as maintaining the exemption even after the payment has been deposited.\textsuperscript{167} In such cases, the depositary will normally not be permitted to set off against those funds.\textsuperscript{168}

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\textsuperscript{163} A corporate or partnership deposit account should be available as collateral even if offered to secure a personal loan to a stockholder or partner. The same should be true for an individual’s deposit account offered to secure a business loan. Such a transaction is unlikely to carry the same potential for abuse that more typical consumer transactions do, since the depositor is likely to have some business acumen.
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\textsuperscript{164} See, e.g., In re Laues, 90 B.R. 158, 160-61 (Bankr. E.D.N.C. 1988) (refusing to allow a bank to set off against a depositor’s account protected by the state’s insolvency exemptions).
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\textsuperscript{165} See I.R.C. § 408(e)(4) (1988) (IRA tax exemption lost if taxpayer assigns rights to it). \textit{See also} In re Gillett, 55 B.R. 675 (Bankr. S.D. Fla. 1985); In re Todd, 37 B.R. 836 (Bankr. W.D. La. 1984); Hall v. Duncan Sav. & Loan Ass’n, 820 P.2d 1360 (Okla. App. 1991) (all relying on that statute to conclude that the bank cannot set off against an IRA account because there is no mutuality). \textit{Cf.} Masi v. Ford City Bank, 779 F.2d 397 (7th Cir. 1985) (IRA account is a special deposit unavailable for setoff).
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\textsuperscript{166} \textit{See, e.g.,} 42 U.S.C. § 407(a) (1988) (exempting social security benefits).
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\textsuperscript{168} \textit{Compare} Kruger v. Wells Fargo Bank, 521 P.2d 441 (Cal. 1974) (refusing to permit bank to set off against deposit account containing unemployment compensation and disability benefits), \textit{with} Daugherty v. Central Trust Co., 504 N.E.2d 1100 (Ohio 1986) (allowing bank to setoff against account containing depositor’s personal earnings, even though statute exempted such deposits from garnishment, attachment, and execution).
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However, if a bank or other creditor obtained a consensual security interest in a deposit account containing such exempt funds, the exemption may well be lost. Just as the depositor may freely transfer these funds in the ordinary course, such as to buy goods or services, the depositor is generally permitted to grant an effective security interest in them. This is problematic and troubling. Consumers are unlikely to understand the significance of depositing exempt payments into a collateralized deposit account. Moreover, unless the secured creditor and consumer truly bargained for a security interest in these types of payments, which seems unlikely, allowing the creditor to foreclose upon such funds would undermine the policy behind the exemption.

Some consumer protection is thus needed to deal with this issue. Initially it might appear that a fairly simple rule could suffice, such as one providing that a security interest in a deposit account cannot extend to funds that would be exempt from attachment, garnishment, and the like. However, such a rule would probably not be adequate. Under such a rule, a consumer’s access to exempt deposits – funds which the consumer may need for necessities – would probably be greatly impaired while the secured creditor’s right to them was adjudicated. Moreover, if consumers had to bear the expense and burden of proving their entitlement to the exemption – an exemption of which they may not even be aware – many would never simply see the money. In short, the rule would merely pretend to protect consumers; consumers would have a transparent but nonetheless solid barrier to enjoying their exemptions. If a more workable rule cannot be fashioned, serious consideration should be given to exempting consumer deposit accounts from the scope of Article 9.

The key point, though, is this: The desire to protect consumers is not an adequate basis for scuttling the entire effort to bring security interests in deposit accounts as original collateral within Article 9. Whether consumer protection is based simply on the need to protect personal exemptions or on the need to respond to all of the arguments raised on behalf of consumers, it is at most a basis for excluding consumer transactions from the proposed change.

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169 See In re Laues, 90 B.R. at 161 (refusing to permit setoff but suggesting that the result would be different if the depositor had granted an effective security interest in the deposit account). Cf. 11 U.S.C. § 522(f) (1988) (allowing a bankruptcy debtor to avoid the fixing of certain consensual liens on some types of tangible property to the extent they impair exemptions, but not allowing the debtor to avoid a consensual lien on funds in a deposit account).

170 Note, this problem is more acute and more complex than that addressed by the Subcommittee. See Subcommittee Report § 4(f), at 12 (dealing only with exempt accounts, not with accounts containing exempt payments).

171 Such an exclusion could be based on either the consumer nature of the deposit account (whether it is used for personal, family, or household purposes) or on the consumer nature of the borrowing. Since depositaries rarely have an adequate basis for knowing how an individual’s account is being used, and since that use may change over time, the better option would seem to make such an exclusion relate to the nature of the depositor’s indebtedness. Thus, if an exclusion for consumers is deemed necessary, an individual borrowing money for personal, family, or household purposes should not be permitted to grant an Article 9 security interest in deposit accounts. If such a consumer truly wishes to collateralize deposits, the consumer can always agree to restrictions that would enable the lender to perfect a common-law security interest or reify the deposits into an instrument then pledged to the lender.
Conclusion

As one notable commentator has put it, “[t]he notion that deposit accounts should be kept outside the scope of Article 9 because they are somehow ‘special’ seems outmoded.”\textsuperscript{172} Fortunately, this view seems to have gained ascendancy, and the upcoming revisions to Article 9 are likely to bring deposit accounts financing within its scope. Such a change in the law should greatly benefit depositaries by making their obligations to secured parties more clear and by allowing them to enhance their own rights to their customers’ deposits. Such changes should also benefit some debtors, by allowing them to collateralize their deposits without restricting their own access to them. As long as the amendments are crafted with care, so that neither the payment system nor consumers are unduly burdened, state legislatures and the commercial world should embrace the changes.

\textsuperscript{172} CLARK, supra note 35, ¶ 14.14, at S14-8.