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Conflicts Between a Bank’s Common Law Right of Setoff and a Secured Party’s Interest in Identifiable Proceeds

It is well established that a bank has a common law right of setoff against funds on deposit with it when the relationship between the bank and the depositor is that of mutual debtor-creditor and the depositor’s debt has fully matured. When the funds on deposit with the bank belong to a person other than the depositor, the majority rule is that the bank’s right of setoff will prevail over the rights of the third person to the monies on deposit if the bank set off without knowledge or notice of the third party’s interest. In minority rule jurisdictions, setoff is allowed only if the bank changed its position in reliance on the deposit.

Section 9-306(2) of the Uniform Commercial Code provides that a security interest continues in any identifiable proceeds resulting from the sale, exchange or other disposition of collateral including collections received by the debtor. Section 9-306(1) of the Code states that if a secured creditor’s collateral is sold or otherwise disposed of by his debtor, whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds will be considered “proceeds.” They may be either cash proceeds, such as money, checks and deposit accounts, or non-cash proceeds.

If a debtor deposits cash proceeds into a bank account other than the creditor’s, and the bank exercises its right of setoff without knowledge or notice that the funds on deposit are proceeds, or after

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1. Setoff has been defined as “that right which exists between two parties, each of whom under an independent contract owes an ascertained amount to the other, to set off his respective debt by way of mutual deduction.” BLACK’S LAW DICTIONARY 1538 (4th ed. 1968).

2. See note 10 infra and accompanying text.

3. See note 21 infra and accompanying text.

4. See note 25 infra and accompanying text.

5. U.C.C. § 9-306(2) (1972 version) [hereinafter cited as 9-306(2)]. Unless otherwise indicated in the text or footnotes, all citations to the Uniform Commercial Code and its Comments are to the 1972 version of the Code.


7. In accounts receivable financing the collateral itself is proceeds; in inventory financing the secured party expects that the inventory will be sold and that he will receive the proceeds, or a portion thereof. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 677, 732 (1st ed. 1965).

8. See notes 86 and 87 infra and accompanying text.
changing its position in reliance on the deposit, will 9-306(2) prevail in the interest of the secured party, or does the bank's right of setoff operate to defeat the interest of the secured party?

**COMMON LAW ORIGINS OF THE RIGHT OF SETOFF**

When money is deposited in a bank, the bank becomes the debtor of the depositor to the extent of the deposit. If the depositor is indebted to the bank on a matured obligation under a separate financing arrangement, a mutual indebtedness arises which the bank may extinguish by setting off its debt against the amount of the depositor's debt. There are, however, restrictions placed on the exercise of setoff. The indebtedness between the bank and depositor must be mutual; the account must not be opened for a special or limited purpose; and the deposit must not be a trust account of which the bank had actual or constructive notice. Most importantly, setoff will be allowed only when the debt to the bank has matured.

The debt of the depositor to the bank may be created simultaneously with, subsequent to, or antecedent to the deposit. Most courts hold that all three situations constitute transfers for value which cut off all prior equities, including those of the depositor. The rule in the simultaneous debt situation results because a deposit is made in exchange for the extension of credit. A subsequent debt situation constitutes a transfer for value since credit is extended in reliance on the existing deposit. Finally, where a setoff is made in satisfaction of an antecedent debt, these courts recognize a transfer for value.

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11. See note 10 supra.


16. A transferee for value took title free of prior equities under the Uniform Negotiable Instruments Law §§ 52, 57, and this position has been continued by U.C.C. §§ 3-302, 3-305.


19. Cf. Swift v. Tyson, 41 U.S. (16 Pet.) 1 (1842); see also, Comment, *Contracts - Bills*
Based on these reasons, the majority of jurisdictions adhere to a knowledge/notice rule in determining rights of setoff against rights of third parties. If a bank has neither knowledge nor notice of facts sufficient to put it on inquiry that the deposited funds actually belong to a third party, it may apply the funds to the depositor’s debt to the bank.

The minority of courts concur with the majority in viewing a simultaneous debt situation as a transfer for value, but hold that subsequent and antecedent debts do not create a greater equity in the bank than the true owner of the funds. These courts, which have adopted an equitable or federal rule, take the position that even though a bank has no express or implied knowledge that someone other than the depositor has an interest in the funds, the bank

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20. Central Nat’l Bank v. Conn. Mut. Life Ins. Co., 104 U.S. 54 (1881), one of the oldest cases supporting the majority position, rests on the premise that setoff “cannot be permitted to prevail against the equity of the beneficial owner, of which the bank has notice, either actual or constructive.” 104 U.S. at 71. The majority rule is subscribed to by approximately 29 states. See Annot., 8 A.L.R.3d 246 (1966); 9 C.J.S. Banks and Banking §§302, 304 (1938); 10 Am. Jur. 2d Banks § 676 (1963); Dobyns, Banking Setoff: A Study in Commercial Obsolescence, 23 Hastings L.J. 1585, 1586 n.8 (1972) [hereinafter cited as Dobyns]. Five of these states subscribe to the majority rule by statute. Dobyns at 1586-87 n.9. The number of states adhering to the majority position is an approximation only.


22. However, since the enactment of the Code, the theory that the satisfaction of an antecedent debt is not a transfer for value has changed drastically. See U.C.C. § 3-303.


24. Bank of Metropolis v. New England Bank, 42 U.S. (1 How.) 234 (1843), aff’d on second appeal, 47 U.S. (6 How.) 212 (1848) stated that the bank’s right of setoff was dependent upon extending credit or allowing balances to remain outstanding upon the faith of negotiable paper “transmitted or expected to be transmitted in the usual course of dealings...” 47 U.S. (6 How.) at 227 (emphasis added). Later judicial interpretations of the case overlooked the Court’s reference to expected funds, and thereby limited a bank’s right of setoff to instances in which the extension of credit was made on the strength of funds presently on deposit.

Although Bank of Metropolis is credited with developing the equitable rule, some commentators argue that this is only the result of a misconstruction of the holding and that the case itself fails to stand for the minority position as it currently exists. See W. Tomlin, Banks and Banking—Equitable Remedies—Set-Off and Counterclaim—Bank Held to Have No Right to Offset Against the Account of Depositor Who Holds Funds in Trust for the Beneficial Owner, Regardless of Absence of Notice to the Bank. National Indemnity Co. v. Spring Branch State Bank, 348 S.W.2d 528 (Tex. 1961), 40 Tex. L. Rev. 394, 395-96 (1962).

This position evolved into the present minority rule which is held by approximately 8 states. See Annot., 8 A.L.R.3d 249 (1966). Note, however, that recently Michigan adopted the knowledge/notice rule, and Oklahoma and South Dakota adhere also to the knowledge/notice rule by statute. See Dobyns, supra note 20, at 1586-87.
cannot apply these funds to satisfy the depositor’s debt unless the bank changed its position, for example, by relying on the deposited funds as security for a loan. This usually occurs in a simultaneous debt situation.

When the third party is a holder of a perfected security interest in cash proceeds which the debtor/depositor has deposited in a general account, the stage is set for a potential conflict between the bank and the secured party over the disposition of proceeds. Central to the resolution of such conflict is an understanding of the concept of identifiability of proceeds. Thus, a brief discussion of that concept follows.

**IDENTIFIABILITY OF PROCEEDS**

Section 9-306(2) provides that a security interest continues in identifiable proceeds. For cash proceeds, however, this continuity is destroyed after a period of ten days, unless the secured party has filed a financing statement for the original collateral. If this procedure is followed, the security interest is continuously perfected in identifiable cash proceeds.

The issue of identifiability of cash proceeds is relevant to a bank’s right of setoff because a security interest does not continue unless the proceeds are identifiable. Hence, a setoff against unidentifiable cash proceeds would not create a conflict between a bank and a secured party, because the secured party has no further interest in the proceeds. When an account contains only proceeds, whether the account be general or special, there is no problem with identifiability. However, when proceeds are commingled with other funds in a general account, a question arises whether the proceeds continue to be identifiable. If they are identifiable, then the security interest

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26. It would seem logical that a bank might also change its position based on an antecedent or subsequent debt situation. In a subsequent debt situation, a bank might extend credit in reliance on the fact that a deposit account already exists against which it could set off. In an antecedent debt situation, a bank might contractually provide at the time it extends credit, that a deposit account be established in the future. However, the courts following the equitable/federal rule do not agree with this analysis.

27. U.C.C. § 9-306(3) [hereinafter cited as 9-306(3)].

28. U.C.C. § 9-306(3)(b) [hereinafter cited as 9-306(3)(b)]. This section provides in pertinent part:

The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless . . . (b) a filed financing statement covers the original collateral and the proceeds are identifiable cash proceeds. . .
remains and any attempt by a bank to setoff against those funds undoubtedly would be contested by the secured party.

Professor Gilmore, the principal draftsman and reporter for Article Nine of the Code, states that commingling proceeds with other funds destroys their identifiability. "If a secured party allows his debtor to make and keep collections, he loses his interest (except for a limited right in insolvency proceedings) when the collections are commingled with other deposits in the debtor's bank account." 29

Under Gilmore's theory, the loss of the security interest is occasioned by the fact that a debtor retains complete control over proceeds deposited in his own general account by virtue of his power over the account. This position is derived from the holding in Benedict v. Ratner. 30 According to that rule, a debtor's dominion over property subject to a security interest, including the ability to dispose of and apply proceeds to his own use, constitutes a fraudulent conveyance as to other creditors, 31 which can be set aside by them, thereby terminating the security interest.

The Benedict rule required, in order to protect a security interest in proceeds, that a separate bank account only for proceeds be maintained by the debtor and policed by the secured party, which made it a simple matter to trace identifiable proceeds. However, as the court in Michigan National Bank v. Flowers Mobile Homes Sales 32 noted: "such cumbersome formalities . . . seem hardly compatible with the stated underlying purpose of the Uniform Commercial Code 'to simplify . . . the law governing commercial transactions' and 'to permit the continued expansion of commercial practices through custom, usage and agreement of the parties.'" 33

Citing 9-205 34 with respect to commingling and 9-306(3) in regard to identifiability, the court could find "no statutory definition of 'identifiable proceeds' . . . .[W]e also find no express limitation on the right of a secured party to trace proceeds subject to his security interest into a bank account of the debtor. This lack of limitation

29. 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 736 (1st ed. 1965). Gilmore also cites the inclusion of a special provision in 9-306(4)(d) for commingled proceeds as further support for his position. According to Gilmore if a security interest in proceeds is not destroyed when proceeds are commingled, then there would be no need to include such a special provision in the insolvency subsection of 9-306. Contrary to this position, the insolvency section was so drafted in order to ease the burden of the secured party on insolvency. Under 9-306(4)(d) a secured creditor is not burdened with identifying proceeds before he can recover.
33. Id. at 694, 217 S.E.2d at 112, citing G.S. § 25-1-102(2) (1975).
34. U.C.C. § 9-205 [hereinafter cited as 9-205].
Conflicts Over Proceeds is not without significance.\textsuperscript{35}

In accord with \textit{Michigan National Bank}, the majority of post-Code decisions\textsuperscript{36} and the Code itself contradict the Gilmore position. Section 9-205 specifically overrules the holding of \textit{Benedict v. Ratner}, and provides that a security interest is not invalid against creditors by reason of the debtor's liberty to use, commingle or dispose of proceeds. The language of this section indicates that the fact that proceeds are deposited into a special or general account is not a critical factor in determining whether a security interest continues in proceeds.

The court in \textit{Brown & Williamson Tobacco Corp. v. First National Bank of Blue Island}\textsuperscript{37} explained 9-205 "is explicit in preserving the priority of the secured party to the proceeds notwithstanding his consent to the sale of the primary collateral and further notwithstanding his consent to the debtor's unrestricted use and disposition of these proceeds so long as they remain identifiable."\textsuperscript{38} The court concluded that despite Gilmore's opinion, an examination of the language of the Code, in view of its purpose, indicates that "the more reasonable implication is that the proceeds may be identifiable, and the security interest therein survive, even though commingled."\textsuperscript{39} Therefore, commingling, in and of itself, cannot be said to destroy identifiability.

However, determining what constitutes identifiable proceeds remains a difficult task. Since the Code does not define "identifiable," many courts have turned to trust law for assistance in ascertaining the meaning of the term.\textsuperscript{40} The relationship between the secured party and his debtor has been likened to that between the beneficiary of a trust and his trustee. Proceeds are therefore equated with trust funds, and identifiability with traceability.

\textsuperscript{35} 26 N.C. App. at 693, 217 S.E.2d at 111.


\textsuperscript{37} 504 F.2d 998 (7th Cir. 1974). See text accompanying note 67 infra for a more complete discussion of the facts.

\textsuperscript{38} 504 F.2d at 1002, quoting \textit{In re Mid State Wood Products Co.}, 323 F. Supp. 853, 857 (N.D. Ill. 1971).

\textsuperscript{39} 504 F.2d at 1002.

\textsuperscript{40} U.C.C. § 1-103 (hereinafter cited as 1-103), provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions."
Under trust principles, it is conclusively presumed that when a trustee deposits trust funds into his personal account, and thereafter dissipates a portion of the funds contained in that account, the amounts so dissipated are personal funds and not trust funds. If the trustee withdraws more than the amount of his own funds, thereby diminishing the trust funds, and subsequently makes additional deposits of personal funds to the account, the beneficiary has no claim to the later deposits, but can only enforce an equitable lien against the account to the extent of the trust funds remaining. This is commonly referred to as the "lowest intermediate balance rule." However, if the trustee deposits personal funds, manifesting an intention to make restitution of the trust funds, the beneficiary can then assert a claim to these additional amounts, as well as to the trust funds remaining in the account. Courts have used this approach to determine whether proceeds are identifiable.

In Brown & Williamson Tobacco Corp. v. First National Bank of Blue Island, the defendant bank set off a personal note against the debtor's corporate account, which contained proceeds subject to a perfected security interest. The bank asserted lack of identifiability of proceeds as a defense.

Looking to Illinois law concerning funds impressed with a trust, the court stated that trust funds may be traced into a fund of commingled assets, and that it is conclusively presumed in equity that a trustee dissipates or spends his own funds first, before invading the trust fund.

In this case, the bank set off nearly one-half of the account, and on the same day paid out most of the remainder in the ordinary course of business by honoring checks drawn by the debtor. The actual order in which these transactions occurred was not considered by the court. The bank argued that the part of the account set off did not contain the secured party's proceeds, but implied that the proceeds were contained in that portion of the account paid out in the ordinary course of business. The issue raised by the bank was not explicitly resolved, but nevertheless the secured party was held to have successfully identified the proceeds.

In Universal C.I.T. Credit Corp. v. Farmers Bank of

41. People v. People's Bank and Trust of Rockford, 353 Ill. 479, 187 N.E. 522 (1933); Perry v. Perry, 484 S.W.2d 257 (Mo. 1972).
42. RESTATEMENT (SECOND) OF TRUSTS §202, Comment j (1959).
43. Id., Comment m.
44. 504 F.2d 998 (7th Cir. 1974). See text accompanying note 67 infra for a more complete discussion of the facts.
Portageville, the plaintiff, a commercial financer, held a perfected security interest in the new car inventory of the debtor automobile dealer, and in the proceeds from their sale. It was the debtor's practice to deposit the proceeds of each car sold into a checking account held with the defendant bank, and to remit payments to the financer in the form of checks drawn on this account. The funds over which the dispute arose derived from the sale of six cars. Upon the sale of each car, the debtor deposited the check received from the purchaser into his checking account. The six deposits were made within a period of twenty-eight days. On the last day, while part of the proceeds remained in the account and remittance checks were outstanding to the secured party, the bank set off against the debtor's account for a debt arising from a demand promissory note.

In a suit by the secured party to recover proceeds from the bank, the court concluded that proceeds would be identifiable if they could be traced in accordance with state law and, in this instance, analogized general accounts containing proceeds to constructive trusts. In tracing the proceeds, the court decided that deposits other than proceeds made by the debtor within the twenty-eight day period had not been made with the intent of restitution. Therefore, only the deposits of proceeds would be treated as additions to a trust fund. Applying the lowest intermediate balance rule, the court subtracted the amount of proceeds remaining in the account at the time the bank exercised its setoff from the balance in the account on that date. The court allowed the bank to keep the remainder, and awarded the traceable proceeds to the secured party. The secured party had shown that the proceeds remaining in the account were identifiable because they had been successfully traced, and therefore the security interest in these proceeds continued under 9-306(3). The secured party was not able to identify those proceeds withdrawn from the account prior to the setoff. Therefore, it held no further security interest in them.

46. See text accompanying notes 41-43 supra.
47. 358 F. Supp. at 325-27.
48. For an example of a situation in which funds in an account are always in excess of proceeds, see Michigan Nat'l Bank v. Flowers Mobile Homes Sales, Inc., 26 N.C. App. 690, 217 S.E.2d 108 (1975). Although this case did not involve setoff, it dealt with principles of identifiability of proceeds. This was a suit brought by a secured party against its debtor and the debtor's judgment creditor. Under applicable state law, the judgment creditor had levied on the debtor's bank account at a time when it contained proceeds, thereby causing the bank to dishonor for insufficient funds a check issued to the secured party by the debtor as payment of proceeds.
Summarizing the approach of these courts, proceeds are identifiable, even if commingled with other funds, if they can be definitely traced from cash proceeds in the hands of the debtor to deposits into his deposit account. Such proceeds can be recovered by a secured party if they were not paid out to a third party in the ordinary course of business, and it will be presumed that other funds in the account are paid out before proceeds. If a secured party can successfully identify proceeds in a bank account using tracing principles under trust law, his perfected security interest continues in the proceeds. Under these circumstances, a secured party's rights inevitably conflict with a bank's right to setoff against an account containing proceeds.

**Effect of the Uniform Commercial Code on Setoff Against Proceeds**

In *Associates Discount Corp. v. Fidelity Union Trust Co.*, a New Jersey trial court held that 9-306(2) of the Code abrogates the common law right of setoff against an account containing proceeds. The secured party in the case held a perfected security interest in nine trucks and any proceeds arising from their disposition. The debtor sold the trucks and deposited the proceeds into its account with a bank. The bank also held a security interest in six other used trucks of the debtor. The debtor defaulted under the bank's security agreement and, after demand for payment remained unsatisfied, the bank set off the amount due against the funds on deposit in the debtor's bank account.

The court stated that under 9-104(i), Article Nine does not apply to any right of setoff, and noted that:

> This section, however, cannot mean that a general creditor, as the bank is here with respect to the funds in question, may abrogate a perfected security interest simply by having a right to and oppor-

Since at all times up to the date of the levy the bank account contained funds sufficient to honor a check in payment of proceeds, the court held that all withdrawals were against funds other than proceeds.

Applying the standard tracing rule, the proceeds from the sale of the original collateral would thus be 'identifiable,' because it is presumed that they remained untouched in the bank from the day of their deposit to the day the checking account was seized. The proceeds in the account thus remained subject to plaintiff's security interest.

26 N.C. App. at 693, 217 S.E.2d at 111.
50. U.C.C. § 9-104(i) (1962 version). The 1972 version of this section provides: "This Article does not apply . . . (i) to any right of setoff. . . ."
tunity for a set-off. All this section means is that a right of set-off may exist in a creditor who does not have a security interest. 51

Pre-Code cases are subject to the "superior authority of the legislature which, by enacting the Uniform Commercial Code, continued the plaintiff's [the secured party's] security interest in the identifiable proceeds of sales of the collateral." 52

Two later decisions have considered the holding of Associates Discount Corp., but have failed to either strongly agree with or criticize its reasoning. In Morrison Steel Co. v. Gurtman, 53 a New Jersey Appellate Court stated: "Whether or not a right of set-off exists is to be determined by the law of New Jersey. This determination is unaffected by the Uniform Commercial Code." 54

The issue in the Morrison case, however, was not whether setoff continued to exist under the Code, but whether, since the adoption of the Code, a bank's right of setoff would be superior to a perfected security interest. Rather than deciding this issue, the court remanded the case to the trial court due to the fact that the bank which had exercised the setoff had not been joined as a party defendant. Although not necessary to its disposition of the case, the appellate court listed several pre-Code New Jersey knowledge/notice cases which "seem[ed] to favor a holding that a right of set-off may exist." 55 Nevertheless, the court noted that Associates Discount Corp. should be consulted to determine the continued validity or relevance of the earlier decisions in light of the language and legislative intent of the Uniform Commercial Code.

Associates Discount Corp. was also discussed by a federal district court in Universal C.I.T. Credit Corp. v. Farmers Bank of Portageville. 56 In that case the impact of Associates Discount Corp. on the continued validity of the knowledge/notice rule was raised. After mentioning the problem, however, no further discussion of the relationship between the two rules ensued. Therefore, a closer analysis of the Code is necessary for a resolution of this issue.

Section 9-104(i) states that Article Nine of the Code does not apply to any right of setoff. This means not only that it is unnecessary to perfect a security interest in order to exercise a right of setoff, but also that setoff law remains totally unaffected by Article Nine's codification of the rights of secured parties. Since Article Nine does

51. 111 N.J. Super. at 356, 268 A.2d at 333.
52. Id.
54. Id. at 481, 274 A.2d at 310, citing N.J. STAT. ANN. 12A.9-104(i) (West) (1971).
55. Id. at 484, 274 A.2d at 312.
not apply to setoff, section 1-103.supra takes effect, making the common
law of setoff supplemental to 9-306. Therefore, it is setoff law, rather
than 9-306, which must be applied to determine whether a proper
setoff against identifiable proceeds has been exercised.

Section 9-306(2) does not directly deny a right of setoff against
proceeds. However, proponents of the rights of secured parties to
identifiable proceeds argue that unless 9-306(2) eliminates a bank's
common law right of setoff against proceeds, the operation of 9-
306(2) is rendered ineffective. This argument is exaggerated since
the right to exercise setoff against third party funds arises only in
certain limited circumstances, and only in those circumstances
would setoff defeat the interest of a secured party in identifiable
proceeds. In all other cases, a perfected security interest under 9-
306(2) prevails.

The conclusion that setoff can defeat a security interest in pro-
ceeds is consistent with other provisions of the Code, which indicate
that despite 9-306(2), the drafters did not intend the rights of a
secured party in proceeds to be inviolate. Security interests in pro-
ceeds can be terminated in a number of ways. One who receives
proceeds from the debtor in the ordinary course of business takes
free of a secured party's claim,58 and a holder in due course of negoti-
able proceeds takes priority over an earlier perfected security inter-
est.59 In view of the deliberate exclusion of setoff from Article Nine
under 9-104(i), the drafters also evidenced an intent that a bank,
properly exercising its right of setoff, should take free of a secured
party's interest in proceeds.60

A basic rule of statutory construction is that when a particular
section of a statute, or the intent of the legislators underlying that
statute is unclear, consideration should be given to similar sections
of the same statute for clarification.61 If the drafters of the Code had

57. See note 40 supra.
59. U.C.C. § 9-309.
60. It would appear that the drafters of 9-306(2) and (3) should have made some provision
for the apparent conflict between setoff and a perfected security interest in proceeds, but the
failure to do so is not without basis in pre-Code law. Uniform Trust Receipts Act § 10, the
predecessor of 9-306(2), generally gave the secured party a claim to the proceeds upon a
debtor's sale of collateral, whether or not the sale was authorized by the secured party.
According to U.C.C. § 9-306, Comment 2(a), in some instances, it was said that the security
interest attached to the property substituted for the original collateral; in others, that the
debtor held the proceeds as trustee or agent for the secured party. However, the common law
right of setoff coexisted with this provision of the Uniform Trust Receipts Act. The present
conflict under the Code easily could have existed under the predecessor statute as well.
61. United States v. Nat'l Marine Engineers Beneficial Ass'n, 294 F.2d 385, 390-91 (2d
Cir. 1961); People ex rel Nordstrom v. Chicago & N.W. Ry. Co., 11 Ill. 2d 99, 106-07, 142
N.E.2d 26, 30-31 (1957).
intended 9-306(2) to abrogate the right of setoff, or for the Code to determine the priorities between 9-306(2) and setoff, a provision similar to that in 9-104(i) could have been inserted into 9-104(i). Section 9-104(i) excludes from Article Nine coverage transfers of interests in deposit accounts, except as to proceeds (9-306) and priorities in proceeds (9-312). The failure to include such a provision in 9-104(i) indicates that the Code was not intended to affect priorities between security interests and rights of setoff.

In a related context, section 9-104(c) excludes artisans' liens from the scope of Article Nine except for the priorities established by 9-310 between such liens and perfected security interests. The drafters could have similarly incorporated a separate priorities section dealing with setoff in 9-104(i). The absence of such a section further evidences their intention that it is the common law, rather than the Code, which resolves conflicts involving setoff against third party funds.

In the event of insolvency proceedings, 9-306(4)(d)(i) specifically recognizes a continuing right of setoff against deposit accounts of the debtor in which proceeds have been commingled with other funds, whether or not a secured party has a perfected security interest in the proceeds. This recognition directly contradicts the assertion in Associates Discount Corp. that the drafters intended to abrogate a bank's common law right of setoff against proceeds. Furthermore, in recognizing the right of setoff against commingled proceeds, the Code has statutorily legitimized this right. By contrast, under pre-Code law the matter was largely left to common law.

**POST-CODE JUDICIAL INTERPRETATIONS OF THE CONFLICT BETWEEN SETOFF AND SECURITY INTERESTS IN IDENTIFIABLE PROCEEDS**

Although Associates Discount Corp. has not been expressly overruled or contradicted, later courts have disregarded its holding and based their decisions regarding priority on pre-Code law rather than 9-306(2) and (3). The interest of a secured party in proceeds deposited in a bank account has been compared to the interest of a third party in funds similarly deposited. Whether or not a secured party has been permitted to recover against a bank which has setoff, depends on whether the particular court follows the knowledge/notice

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62. U.C.C. § 9-104(1) [hereinafter cited as 9-104(1)].
63. U.C.C. § 9-312.
64. This is contrary to the holding of Associates Discount Corp. v. Fidelity Union Trust Co., 111 N.J. Super. 353, 268 A.2d 330 (1970). See text accompanying notes 49-52 supra.
65. U.C.C. § 9-310 [hereinafter cited as 9-310].
or equitable/federal rule.

In Brown & Williamson Tobacco Corp. v. First National Bank of Blue Island, the Court of Appeals for the Seventh Circuit applied the pre-Code knowledge/notice rule adhered to by the state courts of Illinois. In that case a tobacco products supplier (B & W), obtained a security interest in a wholesaler's current and future inventory, accounts receivable, and proceeds of the foregoing.

Four months later, the wholesaler issued several checks to B & W in payment of purchase money advances made to the wholesaler. These checks were drawn on an account containing proceeds from the sale of the wholesaler's inventory and the collection of accounts receivable. Although the balance in the corporate account was adequate to cover the checks, upon presentment by B & W the bank represented that the funds in the account were insufficient. Thereafter, the bank obtained the oral approval and written direction of the wholesaler to debit the wholesaler's corporate account in satisfaction of a personal note of the principals of the corporation held by the bank. At the time, the note was not due. Under these circumstances, the court held that the bank had no right of setoff. It was noted that when proceeds placed in the debtor's checking account are paid out in the operation of the debtor's business, recipients of the funds take free of any claims of the secured party. Because of the bank's unorthodox conduct prior to the time of the setoff, the court found that the transfer was outside the bank's ordinary course of business. Therefore, the court reverted to a variant of the knowledge/notice rule, and charged the bank with constructive notice of the interest of B & W in the account. This holding, together with the fact that the court did not state or imply that 9-306(2) was determinative of the rights or priorities of the

67. 504 F.2d 998 (7th Cir. 1974).

68. The court failed to consider two facts which would have determined the outcome of this case without reference to the Code. The bank set off funds from a corporate account in payment of a personal note. Furthermore, the note on which the bank based its setoff was not fully matured. Since there was no mutual debtor/creditor relationship involved and since the note involved had not yet matured, there was no right of setoff.

69. ILL. Rev. Stat. ch. 26, § 9-306, Comment 2(c) (1973). This comment states in pertinent part:

Where cash proceeds are covered into the debtor's checking account and paid out in the operation of the debtor's business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transforee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.

70. 504 F.2d at 1002-04.
parties, reaffirms the validity of using pre-Code law to determine whether setoff against proceeds is valid.

In *Universal C.I.T. Credit Corp. v. Farmers Bank of Portageville,*\(^7\) pre-Code setoff cases based on the knowledge/notice rule were employed to support a decision in favor of the secured party. The action was brought against a bank by an automobile financer which had a perfected security interest in proceeds of the sale of certain automobiles. Approximately eighteen months after the original security agreement had been entered into between the financer and the debtor, the financer notified the debtor of its intent to discontinue its floor plan financing of the debtor. The debtor subsequently instructed his bank to set off against his account funds due it by the debtor. The debtor’s express intent was to prefer the claim of the bank to that of the financer. The debtor refused, however, to issue a check to the bank, insisting instead that the bank debit his account. The bank complied, and the account, which contained proceeds of automobile sales, was set off. The debtor also informed the bank of checks drawn on the proceeds in his account outstanding to the financer. All of these events, including the debit, occurred after the close of the bank’s business day. When the financer presented the proceeds checks for payment, the bank dishonored them due to insufficient funds.

The court cited 9-306, Comment 2(c) with particular emphasis on that portion of the comment which refers to the law of fraudulent conveyances.\(^7\) It noted that in Missouri, one indicia of a fraudulent conveyance is a transaction outside the usual course of business. Although it did not find a fraudulent conveyance, the court nevertheless held that the debit was outside of the ordinary course of business and therefore could not defeat the secured party’s interest in proceeds. The following facts were critical to this conclusion: (1) the bank knew that there were checks in payment of proceeds outstanding to the plaintiff; (2) the debtor would not issue a check to the bank in payment of his loan but insisted that the bank debit his account; and (3) all of these events occurred after the close of the business day. Although the court apparently sought to ground its decision on the Code, the portion of the comment on which it relied is nothing more than a reiteration of the common and statutory law of fraudulent conveyances, both of which pre-dated the Code.\(^7\)

\(^7\) See note 69 supra.
\(^7\) See generally 37 C.J.S., Fraudulent Conveyances, §§ 1 et seq. (1943).
The court did not confine its discussion to fraudulent conveyances, but further supported its conclusion with pre-Code Missouri setoff cases that followed the knowledge/notice rule. The facts involved in the case were "sufficient to put the bank on inquiry as to the possible trust character of all or part of the funds deposited in [the debtor's] account." Whether the Universal C.I.T. decision is based on the law of fraudulent conveyances or pre-Code setoff law, or both, the result is the same; the opinion does not refer to or rely on 9-306(2) to determine the validity of the setoff.

In Commercial Discount Corp. v. Milwaukee Western Bank, the contest was between a bank which held a fully matured promissory note of the debtor and a secured party with a perfected security interest in the debtor’s accounts receivable and their proceeds. The secured party alleged that it held a prior perfected security interest in the setoff funds, and that the bank knew or should have known of that interest. The bank argued that notwithstanding the security interest, the setoff was authorized by statute in Wisconsin. However, the court disregarded this defense, asserting that the Wisconsin statute did not address itself to third party funds.

The court also did not discuss whether the bank knew, or should have known, that the funds on deposit were proceeds. Instead, it reviewed prior Wisconsin case law dealing with setoff against third party funds. Since the prior case law was unclear as to whether lack of knowledge or notice supported setoff by the bank, the court took the opportunity to specifically adopt the equitable rule.

The equitable rule is the better rule because it eliminates the problems of proving knowledge on the part of an institution. This rule is not harsh as applied to the bank because a bank is in a superior position to all other creditors because it has funds of its debtor at its disposal to immediately seize and apply as setoff . . . . Other creditors can exercise the right of setoff only as a partial or full defense to an action brought against them by the debtor/creditor.

Although not articulated by the court, the reason for the holding in favor of the secured party seems to be the likelihood that the bank had not changed its position in reliance on the deposit.

The Commercial Discount case demonstrates another instance in which a court, presented with a question of the validity of setoff

74. 358 F. Supp. at 325.
75. 61 Wis. 2d 671, 214 N.W.2d 33 (1974).
77. 61 Wis. 2d at 681-82, 214 N.W.2d at 38-39.
78. Id. at 683, 214 N.W.2d at 39.
against identifiable proceeds, declined to use 9-306(2) as the basis for its decision. In this particular case, that fact is especially noteworthy because the court changed Wisconsin setoff law to the equitable rule, which in this case produced a result favorable to the secured party. If the court was only interested in allowing recovery to the secured party, it could have based its decision on 9-306(2). Its failure to do so implies that 9-306(2) is not relevant to the resolution of the conflict between the parties, and that the holding in *Associates Discount Corp.* is incorrect.

These courts resolved the conflict between a bank's right of setoff against proceeds and a secured party's interest in those proceeds based on pre-Code law. Whether these decisions are based on the law of fraudulent conveyances, the knowledge/notice rule, or the equitable/federal rule is of little import. What is significant is that the courts have not adopted the holding of *Associates Discount Corp.* that 9-306(2) abrogates a bank's right to set off proceeds contained in a debtor's deposit account.

Fortunately, there appears to be unanimity among knowledge/notice jurisdictions regarding the definition of notice, as well as the factual situations which result in findings of knowledge.

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79. A generally accepted definition of notice is knowledge of facts which would naturally lead an honest and prudent person to inquiry. A bank will be charged with notice of everything which such inquiry, pursued in good faith, would disclose. *E.g.*, United States v. Booth-Kelly Lumber Co., 246 F. 970 (9th Cir. 1917); German Am. Nat'l Bank of Lincoln v. Martin, 227 Ill. 629, 115 N.E. 721 (1917).

80. Knowledge has been found to exist in many different factual situations. These include: (1) the depositor described by account as one presumptively acting in an official or fiduciary capacity, such as a designation of the depositor as a trustee, *e.g.*, Keeney v. Bank of Italy, 33 Cal. App. 515, 165 P. 735 (1917); Ryan Bros. v. Curwensville State Bank, 382 Pa. 248, 114 A.2d 178 (1955); United State Fidelity & Guar. Co. v. Adoue, 104 Tex. 379, 137 S.W. 648 (1911); (2) in addition to appending a descriptive word to the depositor's name, other facts exist, such as knowledge of the depositor's course of business, familiarity with his financial affairs, or unusual facts connected with the deposit, *e.g.*, Bank of Guntersville v. Crayter, 199 Ala. 599, 75 S. 7 (1917); Shepard v. Meridian Nat'l Bank, 149 Ind. 532, 48 N.E. 346 (1897); Baker v. New York Nat'l Exch. Bank, 100 N.Y. 31, 2 N.E. 452 (1885); (3) a deposit to a debtor's account of a check or note indicating the third person's interest therein, *e.g.*, American Trust & Banking Co. v. Boone, 102 Ga. 202, 29 S.E. 182 (1897); Wegersley v. Midland Nat'l Bank & Trust Co., 184 Minn. 393, 238 N.W. 792 (1931); Hall v. Windsor Sav. Bank, 97 Vt. 125, 121 A. 582, *aff'd on rehearing*, 97 Vt. 142, 124 A. 593 (1933). See also Union Stock Yards Bank v. Gillespie, 137 U.S. 411 (1890), holding that although a bank is not ordinarily bound to inquire as to the source of a depositor's money, much less as to the depositor's obligations to third parties concerning such money, in certain circumstances, such as particular deposits or lines of deposits, the bank is barred from treating the deposit as if it were the depositor's own money. Where such circumstances exist, a bank will be held to have knowledge, imputed or otherwise, that the funds used to satisfy the debtor's indebtedness to it were the property of another. See also *Kern v. Kinsey*, 384 Ill. 180, 51 N.E.2d 126 (1943); *Kamnzer v. Auburn Park Trust & Sav. Bank*, 344 Ill. 200, 176 N.E. 363 (1931); *Chicago Title & Trust Co. v. Central Trust Co.*, 312 Ill. 396, 144 N.E. 165 (1924); *Live Stock Exchange, Inc. v. State Bank of Roseville*, 249 Ill. App. 44 (1928).
Likewise, minority rule states tend to agree on what constitutes a change in position. Therefore, while the law of setoff against proceeds encompasses both a majority and minority rule, it is not further complicated by different interpretations in each of the fifty states.

The failure of the Code to deal with setoff against proceeds allows the dichotomy between the majority and minority positions to subvert one of the main purposes of the Code, i.e., to make the law “uniform among the various jurisdictions.”

Secured creditors and banks, faced with ever increasing interstate transactions, are forced to familiarize themselves with the setoff law of each individual state instead of being able to rely on a uniform code.

**Proposal for Amendment of Article Nine**

Instilling meaning into the term “identifiable” by use of common law concepts pursuant to 1-103 is not particularly vexatious to potential interested parties. However, the use of the common law of setoff in resolving the conflict between setoff and security interests in identifiable proceeds is quite offensive to secured parties. Since the rights of secured parties in proceeds are created by and perfected under the Code, they would prefer that 9-306 take precedence over setoff law.

The enactment of the Code raises the question whether the right of setoff has become obsolete and should be abolished. Setoff has been used by the banking industry frequently throughout the 20th century. Typically, at least in knowledge/notice jurisdictions, a bank does not enter into a financing situation relying only on an account, yet it may very well expect to receive the benefit of setoff in the event of default by the debtor. When a bank has a right of

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It has been held that knowledge of the nature of a business, by itself is not sufficient to put a bank upon inquiry. By analogy, neither should mere knowledge of the existence of a security agreement with a third party under which proceeds are to be paid directly to the third party, be sufficient to place a bank upon inquiry as to the source of funds on deposit with it. See, e.g., Beaver Boards Cos. v. Imbrie & Co., 287 F. 158 (9th Cir. 1923), aff'd on rehearing, Fulton Nat'l Bank v. Hosier, 295 F. 611 (9th Cir. 1923), rev'd on other grounds, 267 U.S. 276 (1925); Kimmell v. Bean, 68 Kan. 598, 75 P. 1118 (1904).


82. U.C.C. § 1-102(2)(c).

83. See note 40 supra.
setoff with the ability to monitor an account and resort to setoff if necessary, a default situation may be permitted to exist with the expectation that additional time will enable the debtor to improve his financial condition. To totally abolish the right of setoff as a resolution to the conflict of interest might create serious confusion in the banking industry, and cause banks to be more cautious in extending financing to individuals and small businesses. Further, banks would be more likely to declare defaults and bring suit on past due notes immediately, in order to avoid involvement in insolvency proceedings, instead of allowing debtors time to informally reorganize.

If setoff is abolished it would become necessary for banks to turn to the courts for adjudication of the respective rights of themselves as creditors and their depositors as debtors. Depositors might well be expected to withdraw all funds from banks prior to the conclusion of such litigation. The possibility of withdrawal in every instance in which a bank sues to recover on a mature obligation of its depositor is a high price for banks to pay in order that secured parties might be free from setoff against proceeds. The cost is especially high when one considers how constantly setoff is exercised and how infrequently it is exercised against accounts containing proceeds. This problem could be solved if the courts allowed a bank to freeze the funds on deposit until a final judicial determination was reached. On the other hand, abolishing setoff would increase the number of filed cases, thus further inundating already overloaded courts. One major benefit of setoff has been that it allows parties to settle issues of indebtedness outside of the courtroom.

One argument in favor of abolishing setoff is that a bank should only have the same opportunities available to other creditors to obtain security for the extension of credit. Because present law allows a secured bank to setoff against funds on deposit rather than going against the collateral it holds, banks have an edge over other secured parties. Even if a bank does not demand security, it still has rights superior to those of other general creditors and a possibility of defeating a secured party’s interest in proceeds.

Since banks exercise setoff on a daily basis, and since there is normally no conflict with secured creditors by so doing, the right of setoff should not be abolished altogether. Instead, Article Nine could be amended to more evenly balance the interest of banks in

84. At present, unless the setoff is improper, the debtor usually does not contest it in court. Thus, setoff conflicts normally involve third parties and banks.
setoff against the interest of secured parties in proceeds, while still allowing setoff to remain a viable right. The drafting of such an amendment, however, would be replete with difficulties.

One possibility is an amendment that would establish a uniform law of setoff. Such a provision would have to regulate the time at which the right of setoff arises, and when that right could be exercised against proceeds.

However, setoff, by its nature, does not come within the specifically stated scope of Article Nine. Section 9-102(2) provides in part: “This Article applies to security interests created by contract. . . .” The Official Comment to this section enlarges on this concept: “The main purpose of this section is to bring all consensual security interests in personal property and fixtures under this Article. . . .” Setoff may be provided for by contract, but it is not created by contract. Furthermore, setoff is not consensual, since it is a unilateral action by a bank, with or without the consent of the depositor. For this reason, setoff was excluded from coverage by Article Nine under 9-104(i). It would therefore be outside of the scope of Article Nine to provide when the right of setoff exists, and under what conditions it is properly exercisable. The goal of a uniform law of setoff created by amending Article Nine is therefore inapposite, if not legally repugnant. Moreover, it is questionable whether an amendment should be that sweeping since the conflict between banks’ and secured parties’ rights arises in a limited context.

In the conflict over identifiable proceeds, a resolution perhaps could be reached by allowing banks, to the exclusion of other creditors, to perfect security interests in deposit accounts, subject to the right of depositors to withdraw from such accounts in the ordinary course of business. Priorities between banks and secured parties with perfected security interests in proceeds deposited into bank accounts could then be determined on the basis of the first to file or perfect rule. While such an amendment would provide an effective priority rule, it would discriminate in favor of banks, and would

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86. U.C.C. § 9-102(2).
87. U.C.C. § 9-102, Official Comment (emphasis added).
88. U.C.C. § 9-312(5)(a). Since a bank would have possession of the funds in the account, it would have to be considered under U.C.C. § 9-305 to have a perfected security interest as of the time of the establishment of the account in a simultaneous debt situation. If the debtor’s obligation to the bank arose subsequent to the opening of the account, the security interest would arise at the time that the debt was incurred, if provision was made therefor in the security agreement. In the antecedent debt situation, a bank would be required to take a security interest in after-acquired deposit accounts under U.C.C. §§ 9-108, 9-204 in order to protect itself.
not eliminate the right of setoff. Indeed, it would give banks the right to take collateral not presently allowed them under the Code, while setoff would continue to exist under common law and statute.\footnote{90} Furthermore, as the Official Comment to 9-104(1) states, while deposit accounts are frequently offered as collateral, "such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law."\footnote{90}

Any attempt to codify a priority system between setoff and a secured party's interest in proceeds, that would continue to rely on common law and setoff statutes to determine when a right of setoff arises, would result in a destruction of the right to setoff against proceeds. The drafting of a section similar to 9-312,\footnote{91} but applicable to setoff, would require a determination as to when the interest of the bank exercising setoff vests. A right of setoff arises when there is a mutual debtor/creditor relationship and when the debt of the depositor is fully matured. However, this is an inchoate interest only. A bank receives an actual interest in an account only when it takes steps to effectuate the setoff.\footnote{92} Therefore, since a bank's interest arises only upon the exercise of setoff, if a security interest in proceeds was perfected before the actual time of setoff, a secured party would uniformly defeat the interest of a bank arising from setoff.

Furthermore, a closer examination of the cases in which setoff was held to be properly exercisable reveals that the courts have not treated setoff against third party funds as a priority problem. The rule in setoff cases is absolute. In knowledge/notice jurisdictions, regardless of seniority and perfection of the interest of the third party, if a bank has no knowledge or notice before exercising setoff against third party funds, the bank prevails.\footnote{93} In equitable/federal

\footnote{89} The Code could not explicitly repeal existing setoff statutes, any more than it would overrule the common law of setoff, since setoff is not a security interest and is not consistent with the terms of Article Nine.

\footnote{90} U.C.C. § 9-104(1), Comment 7.

\footnote{91} U.C.C. § 9-312.

\footnote{92} U.C.C. § 4-303(1)(b); U.C.C. § 4-303, Comment, which provides that the effective time of setoff is when setoff is actually made. See also Baker v. Nat'l City Bank of Cleveland, 511 F.2d 1016 (6th Cir. 1975); Reed v. Barnett Nat'l Bank, 250 F. 983 (5th Cir. 1918); Niblock v. Park Nat'l Bank, 169 Ill. 517, 48 N.E. 438 (1897). Gillett v. Williamsville State Bank, 310 Ill. App. 395, 34 N.E.2d 552 (1941); Whitewater Community & Sav. Bank v. United State Bank of Crystal Lake, 224 Ill. App. 26 (1922); Peoples State Bank v. Caterpillar Tractor, 213 Ind. 235, 12 N.E.2d 123 (1938).

\footnote{93} The courts in knowledge/notice jurisdictions could resolve the conflict in another way. When a secured party perfects a security interest, he is considered under the Code to have given constructive notice to the public of his interest in the collateral. If the courts were to determine that such perfection constitutes notice under setoff law, then the interest of the
jurisdictions, if a bank changes its position in reliance on a deposit, the bank prevails. This is in accord with the very nature of setoff, and should not be changed by an amendment to the Code. If a bank meets the requirements for setoff in the jurisdiction in which it is located, it should prevail against any interest which a secured party might have in proceeds in the account.

This position is consistent with the clear meaning of 9-104(i), with the intent of the drafters of the Code, and with rules of statutory construction. Furthermore, there appears to be no feasible way to amend Article Nine to provide otherwise. It seems unlikely that judicial and legislative bodies, which have established and fostered the law of setoff, would be willing to place it in a position subservient to security interests by judicial reconstruction of the common law of setoff or by legislative action outside of the Code. Even if they would be willing to do so, such a divergence from present setoff law would necessitate a redefinition, if not the destruction, of the entire law of setoff. This course of action would probably result in chaos and widespread opposition within the banking industry. Considering the comparatively infrequent conflicts between setoff and security interests, as opposed to the widespread reliance on and frequent use of setoff by the banking industry, it would appear that such a solution would be neither equitable nor reasonable.

However, Article Nine's treatment of artisans' liens suggests an approach which might be taken with respect to amending the Code to clarify the relation between 9-306 and the common law of setoff. Under 9-104(c), artisans' liens are excluded from Article Nine except as to priority of such liens since "it was thought inappropriate and unnecessary...to attempt a general codification of that lien structure [artisans' liens] which is in considerable part determined by local conditions and which is far removed from ordinary commercial financing." Nevertheless, 9-310 provides a priority rule between artisans' liens and perfected security interests: unless a statute of a particular jurisdiction states otherwise, in all cases an

94. See text accompanying note 57 supra.
95. See text accompanying notes 58-60 supra.
96. See text accompanying notes 61-66 supra.
97. See text accompanying notes 86-92 supra.
98. U.C.C. § 9-104(c).
99. U.C.C. § 9-104(c), Comment 3.
100. U.C.C. § 9-310.
artisan’s lien takes priority over a prior perfected security interest. This rule is based on the premise that an artisan adds to the value of the collateral and has a security interest to the extent that he added to such value. Thus, in theory, a secured party loses nothing by a rule granting the artisan priority.

Setoff resembles the artisan’s lien to the extent that state law determines when the right of setoff arises and when it may be exercised. As in the case of artisans’ liens, state law regarding setoff varies between majority and minority jurisdictions. In addition, setoff is not involved in most commercial transactions. Setoff is dissimilar from artisans’ liens in that a bank adds nothing to the value of the collateral. Therefore, there are no special equities which would arise in favor of banks as they do in favor of artisans.

Nevertheless, a similar amendment with respect to setoff would do much to clarify the position that setoff occupies under the Code. Section 9-104(i) could be amended to include determination as to priorities in proceeds, as does 9-104(l). A new section could then be added which would clarify that state common law and/or statute determines whether a right of setoff exists, and when such a right may be exercised. If a right of setoff exists, then by operation of state law it would take priority over any security interest in proceeds, whether perfected or not.

The benefit of such an amendment would be threefold. First, it would remind creditors to stay abreast of the financial condition of debtors allowed to dispose of collateral. Otherwise, if a debtor defaults on an obligation to a bank which holds a deposit account containing proceeds, the bank might have an indefeasible right to setoff against the proceeds. Second, practitioners would be given direction in resolving the conflict between setoff and perfected security interests in proceeds. Finally, those courts which have demonstrated a tendency to apply Article Nine to determine priorities between setoff and security interests in proceeds would have statutory authority on which to rely when faced with cases involving a bank’s setoff against proceeds.

**Conclusion**

Because the Code excludes setoff from coverage by Article Nine, the courts have looked to common law to resolve the conflict which arises when a bank sets off against an account containing identifiable proceeds belonging to a secured party. Following the thrust of these judicial interpretations, it is possible for a bank’s right of setoff to defeat a security interest in proceeds, even where those proceeds are identifiable and the interest is perfected. Because of
the dichotomy in the common law concerning setoff, banks have different rights to set off against proceeds depending on the jurisdiction in which they are located.

The only way in which to preserve a secured party's interest in identifiable proceeds against a proper exercise of setoff would be to abolish setoff against proceeds. However, the policy developed in favor of setoff over years of judicial and legislative efforts, in addition to the lobbying strength of the banking industry, would militate against such an occurrence. As a preferred alternative, Article Nine should be amended to make it clear that when state law affords a bank a right of setoff, that right will take precedence over a secured party's perfected security interest in identifiable proceeds.

Rose M. Urban