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Jeanne L. Schroeder

David Gray Carlson

THREE AGAINST TWO: ON THE DIFFERENCE BETWEEN PROPERTY AND CONTRACT AND THE EXAMPLE OF DEPOSIT ACCOUNTS IN BANKRUPTCY

Jeanne L. Schroeder[*]
David Gray Carlson[**]

ABSTRACT

In Citizen's Bank v. Strumpf, 516 U.S. 16 (1995), *Justice Scalia announced that deposit accounts are not "property." Five years later, the Uniform Commercial Code was amended to make deposit accounts collateral for the depositary bank maintaining the account, thereby crowding the field previously occupied by the common law right of setoff. Security interests attach to personal "property." Security interests attach to deposit accounts. Deposit accounts, by syllogistic logic, are property. Does this mean that the U.C.C. has overruled the Supreme Court? We argue not. A deposit account is a mere contract in the two-person universe that contract law presupposes. A deposit account is property in a universe of three or more persons. We argue that Justice Scalia can be vindicated by the text of the Uniform Commercial Code and that the 2000 amendments do not overrule the Supreme Court. The investigation reveals the proper vector spaces that contract and property logically inhabit.*

INTRODUCTION

In music, composers occasionally contrast 3-4 rhythm in one line against 2-4 rhythm in another, producing a jerky unstable rhythm. In law, property and contract bear this same uncomfortable rhythmic structure. Property involves (at a minimum) a three-person universe. Contract keeps pace in a two-person world. Suppose A and B enter into a contract. "Property" implies a relation between A and B with regard to a third—a "thing". If B were to assign his rights against A to C, then A's obligations become a thing in this three-party universe of property. However, where the question is simply A's duty to B (or B's duty to A), the "thing" aspect of the relationship falls out of the equation and we remain in the two-party universe of contract.

In *Citizens Bank v. Strumpf*,[1] the Supreme Court relied on this distinction between the two-person universe of contract and the three-person universe of

[*] Professor of Law, Benjamin N. Cardozo School of Law.
[**] Professor of Law, Benjamin N. Cardozo School of Law.
[1] *See* Citizens Bank v. Strumpf, 516 U.S. 16, 17–19 (1995).

property to solve an alleged puzzle in bankruptcy law: the "banker's dilemma."[2] In *Strumpf*, the Court ruled that a bank's administrative hold on a bankrupt customer's deposit account does not violate the "automatic stay" in the customer's bankruptcy. Bankruptcy Code § 362(a)(3) prohibits "any act to . . . exercise control over property of the estate . . . ."[3] According to Justice Scalia, a bank's obligations under a checking account is not "property." Rather, the depositary bank's refusal to honor checks is mere breach of contract and the automatic stay does not prohibit breaches of contract.

Since the *Strumpf* decision, Article 9 of the Uniform Commercial Code (U.C.C.) has been amended to enable a bank security interest in a deposit account maintained by the bank for a customer who is also debtor with the very same bank. In other words, Article 9 now treats a depositary bank's obligation to pay on demand as a "thing" as to which its own security interest, good against the world (more or less), could attach. That is, the modern U.C.C. now treats bank accounts as "property."

As bankruptcy lawyers know, federal bankruptcy law is interstitial law. According to the standard view, the Bankruptcy Code has no definition of "property."[4] The bankruptcy courts must instead take their definition of "property" from state law. The usual citation for this proposition is that tired warhorse, *Butner v. United States*, in which the Supreme Court stated:

> Unless some federal interest requires a different result, there is no reason why such interest [*i.e.*, property interest created under state law]

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[2] *See generally* Benjamin Weintraub & Alan Resnick, *Freezing the Debtor's Account: A Banker's Dilemma Under the Bankruptcy Code*, 100 BANKING L.J. 316 (1983). Later, we shall deny the existence of a banker's dilemma, *See infra* text accompanying notes 370–98

[3] Current Bankruptcy Code § 362(a)(3) was

> amended . . . in 1984 to add the phrase "exercise control over" property of the estate. Although there is no legislative history explaining why this amendment was added, the court in *Amplifier* stated that "Congress evidently believed that the purpose of staying acts for possession was defeated if plaintiffs were still free to try to control or otherwise direct how the debtor used his property. Clearly at some point, 'control' over another's property becomes constructive possession.

In re Weidenbenner, 521 B.R. 74, 79 (Bankr. S.D.N.Y. 2014) (citing Amplifier Research Corp. v. Hart, 144 B.R. 693, 694 (Bankr. E.D. Pa. 1992)). As we shall discuss throughout this Article, "control" is also a term of art unsder the U.C.C. for a mode of attaching and perfecting a security interest in a deposit account and should not be confused with the use of the term in the Bankruptcy Code.

[4] For a critique of this view, *see* David Gray Carlson, *The Federal Law of Property: The Case of Inheritance Disclaimers and Tenancy by the Entirety*, 75 WASH. & LEE L. REV. 3 (2018).

> should be analyzed differently simply because an interested party is involved in the bankruptcy proceeding.[5]

If *Butner* stands for the proposition that federal law has no definition of "property," then perhaps one could argue that *Strumpf* has been overruled. State law now makes it clear that bank accounts *are* property.

Alternately, could one argue that, despite *Butner,* might there now be a federal law of property as least for the purposes of § 362(a)(3)? If so, the U.C.C. would be *incapable* of overruling *Strumpf*'s holding that the bank account is not "property of the bankruptcy estate."

We argue in this Article that *neither* is *Strumpf* overruled *nor* does *Strumpf* articulate a federal property principle. Rather, Justice Scalia's theory of the bank account is *both* correct as a matter of federal property law *and* as a matter of the state common law of property. In short, the U.C.C. does *not* make contractual performance into "property" in a two-person universe. It only does so in a three-person universe. Indeed, this must be the case, or otherwise all breaches of contract by nondebtors would violate the automatic stay—a radical change in bankruptcy law.

Strumpf entails the law of deposit accounts in bankruptcy, which remains surprisingly untheorized and misunderstood in practice. In particular, there remains substantial unresolved issues regarding a bank's traditional right of setoff against a customer's account. In *Strumpf*, Justice Scalia contrasted a setoff that is *prohibited* under § 362(a)(7) with a *permissible* administrative hold or "freeze" without explaining to how to distinguish a freeze from a true setoff. Also untheorized are the differences between a setoff and a security interest of a bank in its customer's account, as well priority disputes between a banker's setoff rights and security interests or judgment liens claimed by third party creditors.

In this Article we tackle a number of these issues. We start first in Part I with some philosophical remarks on the nature of contract and property. In Part II, we examine the modern U.C.C.'s treatment of deposit accounts to show that the U.C.C. adopts the same three-against-two theory that Justice Scalia expresses in *Strumpf*. Finally, in Part III we examine the context in which the *Strumpf* case arose. This Part exposes a great many paradoxes that eluded Justice Scalia in

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5 *See* Butner v. United States, 440 U.S. 48, 55 (1979); *see also* Citizens Bank v. Strumpf, 516 U.S. 16, 55 (1995).

Strumpf, even as he righty saw that, in context, deposit accounts are not property of the bankruptcy estate.

I. CONTRACT V. PROPERTY

A. Can a Bank Have Property in its Own Contractual Obligation?

In *Strumpf*, Justice Scalia insisted that the depositary bank's obligation to its customer is contractual and that deposit accounts are not "property" within the meaning of § 362(a)(3). Does this position require the view that a depositary bank cannot possibly take a security interest in the deposit accounts it maintains for its customer and borrower? After all, U.C.C. § 1-201(a)(35) defines a security interest as "an interest in . . . property."[6] If the depositary account is capable of serving as "collateral"[7] for the depositary bank, then the depositary account is "property," contrary to Justice Scalia's declaration. It would then seem to follow that the 2000 amendments to the U.C.C. have overruled the Supreme Court's *Strumpf* opinion (assuming the U.C.C. is capable of doing so).

Over the years, a few courts[8] and commentators[9] have suggested that it is logically impossible for a depositary bank to take a security interest in its own

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6 U.C.C. § 1-201(a)(35).

7 *Id.* § 9-102(a)(12) (defining "collateral" as "the property subject to a security interest").

8 "Several courts and commentators . . . have concluded that a person cannot have a security interest in one's own property or indebtedness, as a bank would have if it were permitted to maintain a security interest in deposited funds." Stephen L. Sepulnick, *The Problems With Setoff: A Proposed Legislative Solution*, 30 WM. & MARY L. REV. 51, 88–89 (1988). *See, e.g.*, Fletcher v. Rhode Island Hosp. Trust Nat'l Bank, 496 F.2d 927, 935 (1st Cir. 1974), *cert denied*, United States v. Trice, 491 U.S. 1001 (1974):

> Unlike the case with commercial transactions secured by accounts receivable . . . the bank as creditor does not acquire the debtor's right to payment. It has, instead, a right as a debtor to refuse payment, thereby limiting loss. This wholly negative quality is foreign to secured transactions which gave to the creditor an affirmative right to receive or retain something—money, tangible property, or performance of a contract . . . .

Fletcher v. Rhode Island Hosp. Trust Nat'l Bank, 496 F.2d 927, 935 (1st Cir. 1974); *see also* Moreira v. Digital Employees Fed. Credit Union (*In re* Moreira), 173 B.R. 965, 965 (Bankr. D. Mass. 1994) (a lien of a bank maintaining the deposit account "makes no sense"); Bonhiver v, State Bank of Clearing, 331 N.E.2d 390, 398 (Ill. App. 1975) (a setoff "is not a lien, inchoate or otherwise, for the simple reason that one cannot have a lien on his own property"); Gonsalves v. Bank of America Nat'l Trust & Sav. Assoc., 105 P.2d 118, 121 (Cal. 1940) ("The so-called 'lien' of the bank on the depositor's *account* or funds on deposit is not technically a lien, for the bank is the owner of the funds and the debtor of the depositor, and the bank cannot have a lien on its own property") (emphasis added).

9 *See, e.g.*, Alvin C. Harrell, *Security Interests in Deposit Accounts: A Unique Relationship Between the U.C.C. and Other Law*, 23 U.C.C. L. J. 153, 156 (1990) (citing J. NORTON & S. WHITLEY, BANKING LAW MANUAL §11.05(1) (1986)); Thomas C. Mitchell, *The Negative Pledge Clause and the Classification of Financing Devices: A Question of Perspective*, 60 AM. BANKR. L.J. 153, 163, 164 n.54 (1986) (but later

contractual obligation to pay to the order of its customer. Perhaps relevant to this issue is Grant Gilmore's famous "fan dancing" remark. In his classic *Security Interests in Personal Property*, Professor Gilmore commented on old U.C.C. 9-104(*l*), which excluded setoffs from Article 9. Gilmore's remark is significant because the U.C.C., then and now, was designed to govern *any* security interest on personal property "regardless of form."[10] The drafters obviously feared that a court might rule that the provisions of Article 9 would govern setoffs. Professor Gilmore scoffed with disdain:

> (I) *to any right of set-off*. This exclusion is an apt example of the absurdities which result when draftsmen attempt to appease critics by putting into a statute something that is not in any sense wicked but is hopelessly irrelevant. Of course a right of set-off is not a security interest and has never been confused with one: the statute might as appropriately exclude fan dancing. The bank's right of set-off against a depositor's account is often loosely referred to as a "banker's lien," but the "lien" usage has never led anyone to think that the bank held a security interest in the bank account. Banking groups were, however, concerned lest someone, someday, might think that a bank's right of set-off, because it was called a lien, was a security interest. Hence the exclusion, which does no harm except to the dignity and self-respect of the draftsmen.[11]

It is not likely, however, that the learned Professor Gilmore believed it nonsense for a depositary bank to take a security interest in its own obligation to honor checks. One exclusion in old Article 9 that never drew comment was § 9-104(*l*): Article 9 would not apply "to a transfer of an interest in any deposit account (subsection (1) of U.C.C. § 9-105), except as provided with respect to proceeds (U.C.C. § 9-306) and priorities in proceeds (U.C.C. § 9-312)."[12] *This* provision was not dismissed by Gilmore as superfluous for the obvious reason that it was not incoherent for a third party lender to take a security interest in a

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commenting, "Faced with the fact that the commercial world views the bank's right of setoff as the equivalent of a security device, it makes little sense to give decisive weight to the rather metaphysical objection that one cannot have an interest in one's own indebtedness"); Robert E. Olsen, *The Appropriation of Deposits for Debts: Levies, Liens, and Setoffs*, 90 BANKING L. REV. 827, 838 (1973) (referring to the "illogical suggestion that a bank can somehow have a lien on its own property") (footnote omitted).

10 U.C.C. § 9-109(a)(1).

11 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY (1965) § 10.7, at 315–16. Elsewhere, the great Gilmore remarks, a "bank's right of setoff against a depositor's account is often loosely referred to as a 'banker's lien,' but the 'lien' usage has never led anyone to think that the bank held a security interest in the bank account." *Id*. at 316.

12 Old U.C.C. § 9-105(e) defined a deposit account to be "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 evidenced by a certificate of deposit."

deposit account as original collateral. One learns from the Official Comment that "deposit accounts are often put up as collateral. Such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law."[13] Thus, Gilmore may have thought that (1) setoffs are not security interests, and (2) a bank *can* take a security interest in its own obligation to pay, but this would have to be done pursuant to the common law rules of assignment for security (as these security interest were excluded from Article 9 coverage).

Although a few commentators held as incoherent a depositary bank's attempt to create a security interest in its own obligation to pay, others, early in the career of Article 9, found nothing incoherent about this.[14] Even by the time *Strumpf* was decided, courts recognized that banks could take *common law* security interests in their customers' bank accounts. Old Article 9 excluded such security interests from its coverage. But this is not the same as asserting the logical incoherence of the concept. The 2000 revision to Article 9 of the U.C.C. now reverses old Article 9 and expressly promotes the idea that a depositary bank might take a security interest in its own obligation to pay.

If this is so, has *Strumpf* been overruled by state law?

We argue that Justice Scalia's analysis remains both analytically correct *and* consistent with commercial law after the 2000 amendments. The same legal relationship can be simultaneously *contract* in one context and *property* depending on whether we are operating in what we have called a two-party or three-party universe. To put this more precisely, *contractual* rights are only

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13 Old U.C.C. § 9-104 Cmt. 7. In 2000, the drafters would change their tune:

> Except in consumer transactions, deposit accounts may be taken as original collateral under this Article. Under former Sec 9-104(l), deposit accounts were excluded as original collateral, leaving security interests in deposit account to be governed by the common law. The common law is nonuniform, often difficult to discover and comprehend, and frequently costly to implement. As a consequence, debtors who wished to use deposit accounts as collateral sometimes were precluded from doing so as a practical matter.

U.C.C. § 9-109 Cmt. 16.

14 Dwight L. Greene, *Deposit Accounts as Bank Loan Collateral Beyond Setoff to Perfection—The Common Law is Alive and Well*, 39 DRAKE L. REV. 258, 263–71 (1989); Gerald T. McLaughlin, *Security Interests in Deposit Accounts: Unresolved Problems and Unanswered Questions Under Existing Law*, 54 BROOKLYN L. REV. 45 (1988). Commentators noted that the depositary bank's obligation to pay might be reified into a certificate of deposit—a negotiable instrument under U.C.C. Article 3. A certificate of deposit was deemed by old U.C.C. § 9-105(e) *not* to be a deposit account. Therefore, a security interest in a certificate of deposit was governed by Article 9, even if a security interest in a deposit account was not. If the certificate of deposit could be a tangible "thing" separate and apart from the personhood of the lending bank, then why shouldn't the intangible obligation to pay likewise be pledgeable? *Id.* at 49–52.

enforceable directly between and against the actual parties to the contract. *Property* rights, in contrast, are enforceable against "the world" in the sense of an enforceable against at least one third person who is not a party to the contract.

Accordingly, a dispute between a bank and its customer with respect to the payment or nonpayment of a deposit account maintained by that bank is a matter of contract between the bank and its customer. It is not a "property" issue. Justice Scalia was correct that a freeze of a debtor's account is not an "act to . . . control over property of the estate" within the meaning of § 362(a)(3).[15]

The wrongful refusal of a depositary bank to pay to the order of its customer is a breach of contract, but it is not the control of customer property. In contrast, when it refuses to pay *third parties* seeking such funds—such as another secured party or a lien creditor of the customer seeking to garnish the account—the bank asserts a property right in its obligation to pay the customer. Thus, we distinguish between the two-party universe of contract and the three-party universe of property.

B. Multital v. Paucital Rights

Before moving on, we introduce a point about our use of the word "property." As we were supposed to learn in first year law school, only *naifs* use the word "property" to mean a "thing."[16] Sophisticated jurisprudes, in contrast, recognize that property is a legal right and, as such, is a relationship between subjects.[17]

Nevertheless, we sometimes use the term to mean "thing," as the context dictates. One reason we do so is because that is how the U.C.C. uses the term. For instance, collateral is defined in U.C.C. § 9-102(a)(12) as "the property subject to a security interest."[18] The other reason is that we will insist that property always necessarily involves the relative rights and duties of legal subjects with respect to control over a *thing* or *object*. That is, while from a jurisprudential perspective, property cannot be *reduced* to things, it nevertheless must never be *separated* from things.[19]

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[15] 11 U.S.C. § 362(a)(3).

[16] *See, e.g.*, Thomas C. Grey, *The Disintegration of Property*, *in* NOMOS XXII: PROPERTY 69 (J. Roland Pennock & John W. Chapman eds. 22 NOMOS1980).

[17] *Id.*

[18] U.C.C. § 9-102(a)(12).

[19] In Hegelian terms, property is a "reflective" structure relating subject and object. DAVID GRAY CARLSON, A COMMENTARY TO HEGEL'S *SCIENCE OF LOGIC* 257 (2007) ("The trick in Hegel's Reflection is that the object ('*that*') which reflection negates ('I am not *that*') is *Reflection's own selfhood*. Reflection's attribute

What distinguishes property from contract is that property is "objective" in two senses of this polyvalent term.[20] We first invoke a modest definition of "objective"—that which is accepted by convention by a class of subjects[21]—a definition which is, ultimately, contradictory.[22] This is reflected in Wesley Newton Hohfeld's concept of *multital* rights generally enforceable against the "world" understood as a large but countable class of third parties.[23] His examples of multital rights include torts and property.[24] He opposes multital rights to *paucital* rights which are enforceable only against specific identifiable subjects.[25] Contract is the epitome of a paucital right. In other words, Hohfeld makes Justice Scalia's three versus two distinction

Consequently, the issue in *Strumpf*—the proper characterization of a freeze of a debtor's deposit account—is paucital not multital. That is, the bank may perhaps be breaching its contract obligations to the debtor, but it is not converting to its own use the debtor's property rights.

"Property" is also "objective" in a second sense: property rights always involve an "object" or "thing" external to the legal subjects claiming the thing. This is an aspect of property law that is frequently repressed by legal scholars in their attempt to distinguish the legal *right* to property from the naive lay person's understanding of property as a thing. Indeed, Hohfeld went so far as to deny that property involves objects at all.[26]

However, to sever property from its necessary object is to render it unrecognizable. Losing its essential objectivity, property looks like, to invoke the common cliché,[27] a bundle of sticks. Consequently, under Hohfeld's analysis, property cannot be distinguished from tort, also a multital right.[28]

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is that it is *not its own self*. . . A reflective concept is one that is self-repelling ('I am not *that*').") (emphasis in original).

[20] *See generally* Jeanne L. Schroeder, *Subject: Object*, 47 U. MIAMI L. REV. 1 (1992).

[21] *Id*. at 17–24; *see* LIONEL D. SMITH, THE LAW OF TRACING 49(1997) ("Hohfeld probably gave more thought to the terminology of legal relations than almost anyone before or since").

[22] "Truth is conventional" is itself not a conventional truth. For this reason, positivist jurisprudence is a contradiction—a pre-critical philosophy that cannot account for its own position. *See* David Gray Carlson, *Legal Positivism and Russell's Paradox*, 5 WASH. U. JUR. REV. 257, 281 (2013).

[23] WESLEY NEWCOMB HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS AS APPLIED IN LEGAL REASONING 72, 85 (Walter Wheeler Cook ed. 1919).

[24] HOHFELD, *supra* note 23, at 84–85. Rather offensively from a twenty-first century perspective, one of his examples of a multital right is "the right of a father that his daughter not be seduced." *Id.* at 85.

[25] HOHFELD, *supra* note 23, at 72.

[26] HOHFELD, *supra* note 23, at 70, 85.

[27] United States v. Craft, 535 U.S. 274, 278 (2002)

[28] Kenneth Vandevelde, *The New Property of the Nineteenth Century: The Development of the Modern Concept of Property*, 29 BUFF. L. REV. 325, 362 (1980).

Thomas Grey in a famous, or more accurately infamous, influential article subsequently declared property to be incoherent—disintegrating before our eyes and destined for a well-deserved demise.[29] More recently, Josh Fairfield has also denied that property is a law of things, asserting that it is merely a form of information.[30]

The problem with the bundle-of-sticks "theory" of property is that it is, in fact, a non-theory.[31] It confesses a complete failure to account for the persistence of the law's recognition of property as a distinct legal category, let alone the continued inspirational role of private property in the American legal and economic system and constitutional framework. For instance, under "bundle of sticks," where tort cannot be distinguished from breach of contract, every person in breach of contract would be guilty of the tort of conversion, since the breaching person expropriates the property of the other. This is *not* how American law speaks about breach of contract.

Consequently, in recent years academics including ourselves,[32] Alan Brudner,[33] James Penner,[34] and Henry E. Smith[35] have argued that it is the bundle-of-sticks metaphor, and not property and its objectivity, that is incoherent. Property refers to "things,"—a position that is enshrined in the commercial law generally, and the U.C.C. specifically.

Moreover, whether or not one can try to ignore the "thingness" of property in a world without scarcity, in bankruptcy jurisprudence "thingness" is ineluctable. Bankruptcy law consists precisely in determining who can obtain the rights to possess, collect and alienate the debtor's things in order to raise funds to satisfy creditor claims.

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29 Grey, *supra* note 16, at 76–79.

30 Josh Fairfield, *Bitproperty*, 88 S. CAL. L. REV. 805, 844–52 (2015).

31 "Bundle of sticks" is a nontheory in the same way set theory is a nontheory after Russell's paradox. Originally, set theory attempted to define what a set is. That is, set theory was "intensive"—rule-following. Russell's paradox shows that any attempt to define a set leads to contradiction. Therefore, set theory has substituted "bundle of sticks" for set definition and has become an anti-theory. MARY TILES, THE PHILOSOPHY OF SET THEORY: AN HISTORICAL INTRODUCTION TO CANTOR'S PARADISE 175 (1989); Carlson, *Russell's Paradox*, *supra* note 22, at 259.

32 Jeanne Lorraine Schroeder, *The Vestal and the Fasces: Hegel, Lacan, Property and the Feminine In Law and Psychoanalysis*, 16 CARDOZO L. REV. 805, 924 (1994) [hereinafter Schroeder, *Vestal*]; Jeanne L. Schroeder, *Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of Property*, 93 MICH. L. REV. 239, 305 n.188 (1994) [hereinafter Schroeder, *Chix*].

33 *See generally* Alan Brudner, *The Unity of Property Law*, 4 CAN. J.L. & JURIS. 3 (1991).

34 J.E. Penner, *The "Bundle of Rights" Picture of Property*, 43 U.C.L.A. L. REV. 711, 713 (1996).

35 *See* Henry E. Smith, *Property as the Law of Things*, 125 HARV. L. REV. 1691 (2012).

The "thingness" of property is also implicit to the *Strumpf* intuition as to when contract or property rights exists for the purpose of interpreting Bankruptcy Code § 362(a)(3). To understand this, we must consider the jurisprudential definition "thing" or "object."

First, one must not conflate the colloquial understanding of "object" or "thing" as something *tangible*, like a good or realty, with the jurisprudential concept. Indeed, tangibility should not even be considered the criterion of "objectness."[36] Nevertheless it is always tempting to do just that. As we have argued extensively elsewhere,[37] one of the reasons many analysts, including Hohfeld and Grey, deny the "object" of property is that they implicitly make this conflation between objectivity and tangibility. That is, since they cannot imagine an object as being other than tangible, and since property cannot be adequately analyzed in terms of tangibles, they believe that they must reject the object entirely—and perhaps the category "property" as well.

An object is not that which is tangible. Rather, an object is anything that is distinguishable from a legal subject.[38] Here we use the term "subject" to designate that which is recognized as having the capacity to bear legal rights and duties, *i.e.*, a legal person. As such, the "subject" or person is not natural, but is a creature "posited" by "positive" law. To call a corporation an artificial person is not, as often thought, a metaphor.[39] A metaphor implies some natural thing which the metaphor replaces—a constant that is displaced by a mathematical

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[36] *See* Jeanne L. Schroeder, *Unnatural Rights: Hegel and Intellectual Property*, 60 U. MIAMI L. REV. 453, 464–66 (2006) [hereinafter Schroeder, *Unnatural Rights*].

[37] *See* Jeanne Lorraine Schroeder, *The Triumph of Venus: The Erotics of the Market* 179–86 (2004); Schroeder, *Vestal*, *supra* note 32, at 102–228, Schroeder, *Chix*, *supra* note 32.

[38] G.W.F. HEGEL, ELEMENTS OF THE PHILOSOPHY OF RIGHT 71–75 (Allen W. Wood ed. & H.B. Nisbet trans. 1991); Schroeder, *Unnatural Rights*, *supra* note 36, at 464–66. We base our analysis of property on the personality theory explicated by G.W.F. Hegel in his *Philosophy of Right.* Nothing in this article, however, requires acceptance of Hegelian philosophy, though Hegel is rather hard to disprove, and to our knowledge has never been done.

[39] *See* Puerto Rico v. Russell & Co., 288 U.S. 476, 480 (1933) (quoting Klein v. Bd. of Supervisors, 282 U.S. 19, 24 (1930)) ("[a corporation] is a fiction created by law with intent that it should be acted on as if true"). Note that here we are only speaking about American private law, generally, and debtor-creditor law, specifically. We are not addressing fundamental issues such as who positive law *should* recognize as a person, let alone whether or not there are natural rights of personhood. Nevertheless, Hegel argued that "the only thing that cannot be treated as an object is personality itself, understood as the capacity for self-consciousness capable of expressing freedom"—*i.e.*, a human being. Schroeder, *Unnatural Rights*, *supra* note 36, at 464 n. 33 *see* HEGEL, *supra* note 38, at 96. Because, to Hegel, the function of property and the modern constitutional state is the actualization of freedom, we must not treat as objects of property relations those "objects" that are necessary for personality to function—such as the body. Consequently, slavery cannot be tolerated. Jeanne L. Schroeder, *Hegel's Slaves, Blackstone's Objects and Hohfeld's Ghosts: A Comment on Thomas Russell's Imagery of Slave Auctions*, 18 CARDOZO L. REV. 525 (1996).

variable. There *are no constants*, properly speaking, in the language of property rights.

From this perspective, an intangible is every bit an object as a tangible. Most importantly for our project, a right of payment such as an account, a general intangible, a payment intangible—*and a deposit account*—can be objects insofar as they can be distinguished from the subject obligated to pay.

At first blush, one might be tempted to conclude from our discussion that a bank's relationship to its customer should be analyzed as property, not contract, in which case *Strumpf* was wrongly decided. This, however, would violate the two *vs*. three distinction between contract and property.

The U.C.C. honors the two *vs*. three distinction on which Justice Scalia relied. An examination of the U.C.C.'s longstanding and noncontroversial treatment of accounts and account debtors helps to illustrate this. The 2000 amendments to Article 9 can be seen as merely extending this traditional analysis to *deposit* accounts.

Pursuant to its "scope provision," Article 9 applies to transactions creating security interests in personal property[40]—a term that includes sales of accounts and sales of certain other rights to payment.[41] Thus, the definition of "security interest" exceeds "interest in personal property . . . which secures payment or performance of an obligation." It includes the "interest of . . . a buyer of accounts . . . in a transaction that is subject to Article 9."[42]

Meanwhile, U.C.C. § 9-102(a)(2) defines an account as "a right to payment of a monetary obligation" in a number of circumstances including a monetary obligation for "(i) for property that has been . . . sold" and "(ii) for services rendered."[43]

One must further consider the U.C.C.'s idiosyncratic definitions of "debtor" and "account debtor." Under § 9-102(a)(28), a debtor includes "(a) a person having an interest, other than a security interest or other lien, *in the collateral*, whether or not the person is an obligor" and "(B) a seller *of accounts* . . . ."[44] It is singular that under the modern U.C.C., a debtor is no longer defined as a

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40 U.C.C. § 9-109(a)(1).

41 *Id*. § 9-109(a)(3).

42 *Id*. § 9-102(b)(35).

43 *Id*. § 9-102(a)(2).

44 *Id*. § 9-102(a)(28) (emphasis added).

person who owes a debt.[45] That is, the debtor is the owner or seller of the account that is the subject of a security interest held by a secured party. We note that this definition of "debtor" posits an object—"collateral" or "accounts."[46]

In stark contrast to the definition of "debtor," which makes reference to "owning," not "owing," Article 9 defines an "account debtor" as "a person *obligated* on an account . . . ."[47] That is, the "account debtor" is the obligor who owes the "debtor," and the "debtor" is the obligee of the account. Notice that the terms "account debtor," "debtor," and "account" only have meaning *within* the three-party universe of Article 9—a property regime that governs rights of third parties who are not themselves parties to the two-party relationship that created the account. Between the two parties, the relationship is a contract—a debt obligation governed by other law. It would be highly unusual and peculiar for an *obligee* under a debt contract to call himself a "debtor." Rather, between the two parties to the contract, it is the obligor who is the debtor. The obligee is a "creditor."

It is true that, from a philosophical perspective, the obligation owed by an account debtor to a debtor can be conceptualized as a thing that is distinct from the subjectivity of the two parties (and is, therefore, an object).[48] This distinction, however, does not add anything to our understanding of the legal relationship between the two parties at this stage. Rather the law of contract governs the relationship. So, if the account debtor fails to perform her obligation by not paying, she is breaching her contract and the debtor is ordinarily limited to contract remedies, *i.e.*, damages. She is not converting to her own use the property of the debtor. Article 9 does not apply in this two-person universe. Moreover, such a breach would not be an exercise of control over the debtor's property in violation of the automatic stay in bankruptcy.

However, Article 9 applies once the obligee/debtor assigns his rights against the obligor/account debtor to a third party—*i.e.*, a secured party. Now one recognizes the objectivity or thingness of the account because we have entered the three-person universe. The account is now "collateral" defined, in relevant

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[45] This is a change from old Article 9, which defined "debtor," inter alia, as "the person who owes payment . . . ." Old U.C.C. § 9-105(1)(d).

[46] Likewise, the second element of the tripartite condition of "attachment" requires that "the debtor has rights in the collateral or the power to transfer rights in the collateral . . . ." U.C.C. § 9-203(b)(2).

[47] U.C.C. § 9-102(a)(3) (emphasis added).

[48] And indeed, Hegel does so, for example analyzing employment as an exchange of objects, *i.e.*, services for wages. HEGEL, *supra* note 38, at 112. Hegel adds the caveat "insofar as there are alienable" because a complete alienation of one's productive capacity would be slavery which is inconsistent with property's function of actualizing freedom.

part, as "the property subject to a security interest . . . [including] . . . accounts . . . that have been sold." Article 9, then, encompasses property in a three-person universe and restricts contract in the two-person sub-universe.[49]

This distinction between contract and property can also be seen in Article 2 which governs *contracts* for the sale of goods.[50] It is a common misunderstanding that Article 2 does away with "title" in the sale of goods. This is incorrect. Indeed, a sale is defined by U.C.C. § 2-106(a) as "the passing of *title* from the seller to the buyer for a price."[51]

As we have shown elsewhere,[52] what Karl Llewellyn intended to do in Article 2 was not to get rid of "title," which is just another word for property or ownership in goods. Rather, he sought to reform the pre-Code common law instinct to resolve all legal issues with respect to sales by reference to the location of title.

Llewellyn thought that the conceptual error of the common law was *precisely* the conflation of contract and property. That is, it treated every aspect of sales as a subset of conveyancing[53]—*i.e.*, the creation of a right of the buyer in the good that will be enforceable against the third parties not party to the contract of sale. Although he recognized that sales always involved the conveyance of an object—in Article 2's case, the conveyance of "goods"[54]—Llewellyn insisted that not every aspect of sales in a modern mercantile economy can be reduced to conveyancing. Many of the rights and potential disputes arising in a contract for sale only involve the two parties to the contract itself.

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[49] Just as Article 9 recognizes that, although in the two-party universe of a bank's relationship to its customer, a deposit account is a contractual obligation to pay a debt, in the three-party universe that includes other creditors, a bank can take a security interest in its obligation. The Bankruptcy Court for the Northern District of Texas has recognized that an account debtor can take a perfected security interest in its obligation under an account enforceable in bankruptcy. Tusa-Expo Holdings, Inc. v. Knoll, Inc., 496 B.R. 388, 408 (Bankr. N.D. Tex. 2013).

[50] *See* Thomas E. Plank, S*ecurity Interests in Deposits Accounts Securities Accounts, and Commodity Accounts: Correcting Article 9's Confusion of Contract and Property*, 69 OKLA. L. REV. 339, 343–44 (2017).

[51] U.C.C. § 2-106(1) (emphasis added).

[52] Schroeder, *Vestal*, *supra* note 32, at 186–208; Jeanne L. Schroeder, *Some Realism About Legal Surrealism*, 37 WM. & MARY L. REV. 455 (1996).

[53] In Llewellyn's words "Title-thinking [is] sales law viewed as property law. . . ." Karl N. Llewellyn *Through Title to Contract and a Bit Beyond*, 15 N.Y.U. L. Q, REV. 159, 191 (1939) [hereinafter Llewellyn, *Title*]; *see also* KARL N. LLEWELLYN. CASES AND MATERIALS ON THE LAW OF SALES 64 (1930) [hereinafter LLEWELLYN, SALES].

[54] *See* U.C.C. § 2-106(1) ("Contract for sale' includes . . . a present sale of goods . . . .").

Specifically, Llewellyn accused the common law of picturing the archetypical sale in a "farmer's transaction," such as a sale of a horse.[55] In primitive agricultural society, a sale was an event. One farmer would buy a horse from another for cash after inspection. All incidences of ownership passed at once and there was little need to consider such issues as warranties, risk of loss, or failure to pay or accept since everything would take place at the moment when title passed—*i.e.*, when the new owner pays cash and rides off on old Dobbin.[56]

A sale, in the modern mercantile era, is typically a process that unfolds over time. Merchants may agree to a sale of goods to be produced and delivered in the future, at a distant location and paid for by credit.[57] When sale is considered as a process, it becomes apparent that such issues as risk of loss, delivery, breach of contract, non-payment, etc., are contract issues separate from the conveyancing of the title in the goods to be sold. That is, such issues are essentially financial disputes that involve only the two contracting parties.

These issues must be considered on their own terms based on practical considerations. This is why U.C.C. § 2-401 provides that "every provision of this Article with regard to the rights obligations and remedies of the seller, the buyer, purchasers or other third parties applies irrespective of title to the goods *except where the provision refers to such title*."[58] This does not necessarily mean that Article 2 will resolve sales disputes differently from the common law. Llewellyn thought that common law judges often reached sensible conclusions, but only by going through needless metaphysical contortions in order to conform to "title analysis."[59] Article 2 was designed to arrive at common sense solutions in a simpler and more predictable manner. It applies contract principles to contract issues and property principles to property issues. Article 2 thus conforms to the three-against-two rhythm of property and contract.

II. DEPOSIT ACCOUNTS

Just as Article 9 distinguishes between the property and contract aspects of *accounts*, the U.C.C. generally distinguishes the contract and property aspects

[55] Karl N. Llewellyn, *Across Sales on Horseback*, 52 HARV. L REV. 725, 727 (1939) [hereinafter Llewellyn *Horseback*]. Llewellyn's exemplar of the farmer's transaction explains the title of this article and its companion piece, Karl N. Llewellyn, *The First Struggle to Unhorse Sales*, 52 HARV. L. REV. 873 (1939) [hereinafter Llewellyn, *Unhorse*].

[56] Schroeder, *Vestal*, *supra* note 32, at 195–96; LLEWELLYN, SALES, *supra* note 53, at 204, 561.

[57] Schroeder, *Vestal*, *supra* note 32, at 198, 202; Llewellyn, *Title*, *supra* note 53, at 169; Llewellyn, *Horseback*, *supra* note 55, at 732.

[58] U.C.C. §2-401 (emphasis added).

[59] Llewellyn, *Unhorse*, *supra* note 55, at 876, 894.

of *deposit* accounts. Article 4 (Bank Deposits and Collections)[60] and to some extent Article 3 (Negotiable Instruments)[61] apply to the contractual aspect, and Article 9 refers to the proprietal aspect, although Article 9 also mediates some aspects of the interaction between contract and property rights. Article 4, supplemented by federal law,[62] contractual agreement, and clearing house rules, governs the collection and payment of checks. Part 4 specifies the basic obligation of a bank to pay properly payable checks.[63] It does not, however, grant banks a right of setoff, which originates in the common law. Implicitly, Article 4 presupposes setoff rights in the concept of "properly payable" items—a phrase that is not defined in the statute.

Originally Article 9 excluded first-generation security interests in deposit accounts from its scope.[64] According to the dubious rationale set forth in Official Comment 7 to Old U.C.C. § 9-104: "Rights under . . . deposits accounts [are] adequately covered by existing law."[65] As already discussed,[66] setoffs were also excluded by old § 9-104(*l*), the exclusion Professor Gilmore derided. We discuss setoffs, how they differ from security interests, and their treatment in *Strumpf* shortly.[67]

Over time the exclusion of first-generation security interests in deposit accounts proved problematic. As stated in Official Comment 16 to U.C.C. § 9-109:

> The common law is nonuniform, often difficult to discover and comprehend, and frequently costly to implement. As a consequence, debtors who wished to use deposit accounts as collateral sometimes were precluded from doing so as to a practical matter.[68]

Furthermore, it was unclear as to how common law security interests in deposit accounts interacted with U.C.C. concepts, particularly because Article 9 always did govern *second*-generation security interests in deposit accounts insofar as they constituted identifiable cash proceeds.

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60 U.C.C. § 4-101.

61 *Id.* § 3-101.

62 Most specifically Regulation CC, a rule of the Federal Reserve Bank. 12 C.F.R. Pt. 229.

63 U.C.C. § 4-402(a) ("a payor bank wrongfully dishonors an item if it dishonors an item that is properly payable . . . .").

64 Old U.C.C. § 9-104(*l*) (Article 9 does not apply "to a transfer of an interest in any deposit account . . ., except as provided with respect to proceeds . . . and priorities in proceeds . . . .").

65 Old U.C.C. § 9-104 Cmt. 7.

66 *See supra* text at notes 10–13.

67 *See infra* text at notes 308–16.

68 U.C.C. § 9-109 Cmt. 16.

Prior to 2000, courts did often recognize that a bank could take a first-generation security interest in its own obligation under a deposit account, but they struggled with the concept if the deposit account was not evidenced by an indispensable instrument such as a certificate of deposit or passbook.[69] Courts invented the bizarre concept of a "pledge" of a deposit account—bizarre because the term "pledge" connotes the physical delivery of tangible collateral to a creditor. By analogy, and perhaps haunted by the spirit of *Benedict v. Ratner*,[70] a "pledge" was accomplished by depriving the customer of control over the deposit account. In *Benedict*, the Supreme Court, interpreting New York state fraudulent conveyance law,[71] voided what we would today call a non-notification assignment of an the account because the assignor continued to exercise dominion over the account.[72] Similarly, courts would not enforce a first-generation interest in a deposit account if the debtor retained any ability to write checks or otherwise control the account.[73] As a practical matter, only original

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[69] For discussions of pre-2000 law, *see generally* McLaughlin, *supra* note 14; Alvin C. Harrell, *Security Interests in Deposit Accounts: A Unique Relationship Between the U.C.C. and Other Law*, 23 U.C.C. L. J. 153 (1990); Steven L. Harris, *Non-negotiable Certificates of Deposit: An Article 9 Problem*, 29 U.C.L.A. L. REV.330 (1981).

[70] *In re* Hub Carpet, 282 F. 12,14 (2d Cir. 1922), *rev'd sub nom.* Benedict v. Ratner, 268 U.S. 353 (1925); McLaughlin, *supra* note 14, at 68–69; Julian B. McDonnell, *Is Revised Article 9 a Little Greedy?,* 104 COM. L. REV. 241, 260 (1999).

[71] The case was brought under the trustee's strong arm power, Bankruptcy Act § 47a (repealed), which bestowed upon a bankruptcy trustee the rights of a lien creditor under state law. Thus, if a lien creditor could avoid the security interest as a fraudulent conveyance under New York law, the trustee's rights would be senior to those of the secured party. The U.C.C. rejects the specific rule of *Benedict v. Ratner* that an assignment of an account is constructively fraudulent unless the assignee has dominion. It enables non-notification assignments if perfected by filing. *See* Old U.C.C. § 9-205 cmt. 1. We have elsewhere defended *Benedict* on the ground that in the specific facts of the case, it is not clear that a bona fide assignment had in fact been made. Moreover, the U.C.C. in fact recognizes the Supreme Court's concern that to be enforceable against third parties, a property claim must be objectified in a way that is recognizable by third parties against the claim will be asserted. Indeed, Hegel thought that objectification—which he called possession—was logically necessary to property. However, just as an object cannot be limited to tangibles, the concept of possession, Hegel thought, cannot be limited to *physical* possession (which is how the term is used in the U.C.C.) but includes other forms of publicity. The U.C.C. calls its requirement of objectification "perfection."

[72] Debtor retention of control remains a "badge of fraud" for the purposes of fraudulent transfer law. UNIF. FRAUDULENT TRANSFER ACT § 4(b)(2).

[73] Robert J. Skilton, *The Secured Party's Rights in a Debtor's Ban Account Under Article 9 of the Uniform Commercial Code (and Related Matters)*, 1977 S. ILL. U. L.J. 120, 196. The classic case of whether control existed was Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548 (2d Cir. 1975). In *Miller*, a New York bank was charged with receiving a voidable preference. The bank defended by claiming it had a security interest in the debtor's Luxembourg deposit account. If so, the trustee's prima facie case against the bank would crash on the shoals of what is now Bankruptcy Code § 547(b)(5)—the hypothetical liquidation test that permits fully secured creditors to be paid with unencumbered funds. The bank claimed it controlled the Luxembourg account because it had knowledge of a telex key that provided access to the deposit account. The claim of control was ultimately rejected because the bank's knowledge of the telex key did not prevent the debtor or others from depleting the account to the prejudice of the bank.

(*i.e.*, non-proceeds) security interests in dedicated deposit accounts—so-called "lock boxes"—were valid.[74]

The 2000 revisions of Article 9 provided for the creation of security interests in deposit accounts as original collateral, except in consumer transactions where the common law continues to control. New Article 9 contemplates that a bank can take a security interest in accounts that it maintains. In most cases, "a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another party."[75]

A. Distinguishing Setoffs and Security Agreements

The 2000 Amendments raise at least two related questions. How does such a security interest differ from the bank's right of setoff? What does it mean for a bank to take a security interest in an account it maintains? The answers to both of these questions yield insight into the *Strumpf* claim that deposit accounts are not property of the bankruptcy estate.

1. Attachment and Perfection

In distinguishing between a bank's security interest in the deposit account it maintains and its setoff right, one simple and perhaps trivial point is that the requirements of attachment and perfection of a security interest do not apply to setoffs. A debtor must enter into a *security agreement* to create a security interest in a deposit account.[76] Not so with the bank's right of setoff, which arises by operation of law, not from the debtor's agreement.

Under Article 9, attachment of a security interest requires a security agreement.[77] Typically, a security agreement must contain a description of the

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[74] McLaughlin, *supra* note 14.

[75] U.C.C. § 9-327(3). Of course, under general Article 9 principles, the bank could enter into an intercreditor agreement subordinating its interest to another secured party. U.C.C. § 9-330. Indeed, a secured party can only gain "control" (the preferred method of perfection) by entering into a three-party agreement with the debtor-customer and the bank providing that "the bank will comply with instructions originated by the secured party. . . ." One might suppose that banks would agree to do so when they are asked to maintain "lock box" or other dedicated deposit accounts for secured parties.

U.C.C. § 9-327(4) provides the one exception to this rule that the bank always wins—the bank at which the deposit account is maintained is subordinate to secured party who gains control over that deposit account by "becom[ing] the bank's customer with respect to the deposit account" under U.C.C. § 9-104(a)(3). Of course, since deposit accounts are contracts, the bank can protect itself from losing priority by refusing to allow the rival secured party to open a deposit account.

[76] *Id.* § 9-203(b)(3)(D).

[77] *Id.* § 9-203(b)(3).

collateral and must be authenticated.[78] The 2000 Amendments permit an alternative, in which the secured party takes "control"[79] of the deposit account. In cases in which control is the mode of perfection, an *oral* security agreement suffices for a security interest to attach (although, to avoid litigation, prudence loudly demands that a bank obtain written documentation).

A security interest in non-consumer deposit accounts may be perfected by control.[80] Indeed, for original, first generation collateral security interests, control is the *exclusive* means of perfection. Because the bank maintaining the deposit account *always* has control, an attached security interest claimed by that bank is always perfected.

This distinction between security interests and setoffs (*i.e.*, the role of a security agreement) remains salient with respect to consumer debtors, because U.C.C. § 9-109(c)(13) continues to exclude from the scope of Article 9 "an assignment of a deposit account in a consumer transaction" except for the provisions relating to proceeds and their priority.[81] This means that the common law of security interests in deposit accounts[82] continues to apply. As a practical matter a bank cannot obtain an enforceable original first-generation security interest in a consumer deposit account it maintains (in contrast to a second-generation security interest in proceeds deposited in the account) if the debtor retains the right to withdraw funds or otherwise controls the account. No such restriction would apply to the bank's right of setoff in the same account.

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[78] *Id.* § 9-203(b)(3)(A). Early versions of Article 9, assuming that agreements were embodied in a physical writing, required that this agreement be "signed." Old U.C.C. § 9-203(1)(a). The new language anticipates the use of electronic contracting. *Id.* § 9-102(a)(7)(B).

[79] *Id.* § 9-203(d)(3)(D). U.C.C. § 9-104 reads:

> (a) A secured party has control of a deposit account if:
> (1) the secured party is the bank with which the deposit account is maintained;
> (2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or
> (3) the secured party becomes the bank's customer with respect to the deposit account.
> (b) A secured party becomes that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.

U.C.C. § 9-104(a)–(b).

[80] *Id.* § 9-314(a).

[81] *Id.* § 9-109(a)(26) defines "consumer transaction" as:

> a transaction in which (i) an individual incurs an obligation primarily for personal, family, or household purposes, (ii) a security interest secures the obligation, and (iii) the collateral is held or acquired primarily for personal family, or household purposes. The term includes consumer-goods transactions.

[82] *See supra* text accompanying notes 13–14.

2. *"Use it or Lose it" vs. Proceeds*

An important substantive difference between the two-party contractual right of *setoff* and a three-party property right implied by a *security interest* is that a setoff is subject to the rule of "use or lose it" while the latter is not. That is, a setoff right is only the counterbalancing of one contract claim against another—namely the bank's obligation to repay the balance of the deposit account to its customer applied against any amount the customer owes to the bank. Consequently, a setoff right exists only so long as the bank's obligation to the customer does. If the bank allows the customer to withdraw the balance, the bank, as a practical matter, loses its setoff opportunity. Its only recourse is to pursue its rights against the customer under its loan contract. It cannot pursue any third party for conversion of funds to its own use. That is, the deposited funds in the account did not "belong" to the bank.[83] The bank has no "property" interest in these funds. So no third party can take these funds in violation of the bank's property rights. By paying a check (or debit card, or wire transfer or automatic clearing house payment order), the bank has failed to assert its defense of setoff.

[83] That the customer has no property right in deposited funds has been recognized since at least the mid-19th century. Sepulnick, *supra* note 8, at 71. However, the secured party's rights are often obscured by the language used by even sophisticated analysts which seem to suggest that because the customer no longer owns deposited funds, the bank must own them. For example, McLaughlin states:

> Legally, when a depositor deposits money in a bank account at a depositary bank, the depositor no longer owns the funds. The depositary bank owns the funds and the depositor merely retains the right to withdraw those funds. Once the deposit is made, a debtor-creditor relationship is formed; the depositary bank becomes a debtor liable to repay the amount of the deposit upon withdrawal by the creditor-depositor.

McLaughlin, *supra* note 14, at 61. Similarly, Harrell notes:

> one of the legal conundrums inherent in any claim by a depository bank to a lien or security interest in a deposit account held at that institution: Funds deposited in a general deposit account become property of the bank (subject to an obligation of repayment) and no one can have a lien on his or her own property.

Harrell, *supra* note 9, at 175–76. These passages take seriously the antiquated and obsolete language of deposits that reflects the ancient practice whereby merchants would actually physically deliver their coins to bankers for safekeeping. The language is now metaphoric, at best, and misleading, at worst. As McLaughlin and Harrell obviously know (implicitly in the language quoted), a bank holds no separately identifiable of traceable funds reflecting any specific deposits made, or for depositors generally. Deposits are commingled with the bank's working capital and are used to fund its lending business. Although federal and state law require that banks maintain liquidity, these reserves are not required to be segregated or earmarked.

In other words, once "deposited," funds are no longer "funds" in the usual sense of the term. Indeed, the customer does not really "deposit" funds, rather it makes an unsecured loan to the bank. The customer does not subsequently "withdraw" funds, rather it demands that the bank repay the loan.

By way of example, assume that Customer C has deposited $100 in a deposit account with Bank B and that Bank B lends C $80. C has not granted a security interest in the deposit account to B. Consequently, B has only a right of setoff against C for $80. If C were to write a check on the deposit account in the amount of $100 to pay S, the seller of some widget, and if Bank B pays the check instead of declaring the right of setoff, Bank B has lost its setoff right, and it has no claim against S for the amount. It only has an unsecured claim for $80 against C in accordance with the terms of the loan. Meanwhile C owns the widget free and clear of any property right of Bank B.

In sharp contrast, a security interest is not under the rule of "use it or lose it." Rather, a security interest in the bank's obligations implies a security interest in the proceeds of the deposit account.[84]

Assume now that C *has* granted a security interest in the deposit account to Bank B to secure the $80 loan. Because a depositary bank has control over the deposit account it maintains, this security interest is self-perfecting. Once again, C writes a check to S in order to buy a widget, a check which Bank B pays. U.C.C. § 9-332(b) provides that S "takes the funds free of [Bank B's] security interest in the deposit account unless [S] acts in collusion with [C] in violating the rights of [Bank B]." However, this time pursuant to U.C.C. § 9-315(a)(2), Bank B's security interest attaches to the widget as proceeds of the deposit account. Bank B is still a secured creditor of C.

If Bank B is relying solely on control as its means of perfection, however, this proceeds security interest in the widget might prove to be fleeting. Pursuant to U.C.C. § 9-315(d), B's security interest in non-cash proceeds will become:

> unperfected on the 21st day after the security interest attaches to the proceeds unless:
>
> > (A) a filed financing statement covers the original collateral;
> > (B) the proceeds are collateral in which a security interest may be perfected by fining in the office in which the financing statement has been filed; and
> > (C) the proceeds are not acquired with cash proceeds.[85]

To continue perfection past the 20th day, B must take action (usually filing a financing statement with an appropriate description) to reperfect the security interest in the proceeds.[86]

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[84] *See* U.C.C. § 9-315(a)(2).
[85] *Id*. § 9-315(d).
[86] *See* Harrison v. N.J. Cmty. Bank (*In re* Jesup & Lamont, Inc.), 507 B.R. 452 (Bankr. S.D.N.Y. 2014).

Bank B could not have avoided this by filing a financing statement against C with respect to the *deposit account.* Filing is absolutely ineffective as a means of perfecting an original security interest in a deposit account. If Bank B could anticipate what the proceeds would be, of course, it might try to negotiate with C to file a financing statement specifying that type of collateral. However, because such a filing would give Bank B priority over any subsequent lender who wanted to take a security interest in that category of collateral, one would expect C to resist. In such a case Bank B will have to wait for the security interest on the widget to come into existence and then file a new financing statement before the temporary perfection lapses.[87]

3. Priority Disputes

Priority distinguishes the depositary bank's security interests in nonconsumer deposit accounts it maintains for its customer and its right of setoff. As mentioned, common law courts, haunted by the ghost of *Benedict v. Ratner,*[88] were hostile to such security interests—making them difficult to create and to perfect. In addition, courts tended to subordinate the common law security interest in the deposit account to rival Article 9 security interests in cash proceeds that were deposited in the account.[89] In contrast, 2000 amendments heavily favor the depositary bank over third parties claiming deposited cash proceeds.

The basic priority rule is simplicity itself: the depositary bank wins,[90] with one easily avoided exception.[91] The rule[92] is set forth in U.C.C. § 9-327:

> (1) A security interest held by a secured party having control of the deposit account . . . has priority over a conflicting security interest held by a secured party that does not have control.
>
> . . .

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[87] *See* U.C.C. § 9-509(c) (authorizing secured party to file a financing statement on proceeds).

[88] *In re* Hub Carpet, 282 F. 12, 14 (2d Cir. 1922), *rev'd sub nom.* Benedict v. Ratner, 268 U.S. 353 (1925); McLaughlin, *supra* note 14, at 68–69; Julian B. McDonnell, *Is Revised Article 9 a Little Greedy?*, 104 COM. L. J. 241, 260 (1999).

[89] Dag Wilkerson, *Third-Party Interests in Deposit Accounts and the Bank's Right of Setoff*, 109 BANKING L.J. 247 (1992).

[90] Bruce Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI. KENT L. REV. 963, 1027 (1999).

[91] The depositary bank might lose if it grants control of the depositary account to some third party claiming the account as original collateral. *See supra* note 74-75.

[92] The rule is based on the rule for securities accounts adopted in the 1994 amendments to the Articles 8 and 9. Jeanne L. Schroeder, *Bitcoin Under the Uniform Commercial Code*. 24 U. MIAMI BUS. L. REV. 1, 33 (2016).

> (3) Except as otherwise provided in paragraph (4), a security interest held by the bank with which the deposit account is maintained has priority over a conflicting security interest held by another secured party.[93]

We will turn to the exception of paragraph (4) shortly.[94] If it does not apply, and if the bank has not contractually subordinated its interest,[95] the bank prevails over all other secured parties claiming deposits.[96] Indeed, Official Comment 4 expressly provides that the bank's superpriority applies "regardless of whether the deposit account constitutes the competing secured party's original, first generation collateral *or its proceeds*."[97] The Official Comment continues on to suggest that the cash proceeds claimant can protect itself either by complying with paragraph 4 or by setting up a lock-box arrangement with the debtor and obtaining an intercreditor agreement. However, the Comment notes:

> But if the debtor violates its agreement and deposits funds into a deposit account other than the cash-collateral account, the secured party risks being subordinated.[98]

Although the cases do not invoke it, further support of this position is to be found in U.C.C. § 9-327(a), which states that security interests perfected by means other than control are subordinated to the security interests perfected by control. Under the perfection rules (Part 3 of Article 9), the *only* way to perfect original security interests in deposit accounts is through control and the only type of security interests in deposit accounts that can be perfected by means *other* than control are security interests in proceeds deposited in that account.

In other words, the priority rule of U.C.C. § 9-327(1) *must* operate to the prejudice of proceeds security interests since that is the only type of security interest in deposit accounts that can be perfected by means other than control.

U.C.C. §9-327(4) sets out the only exception to the "banks always win" rule: "A security interest perfected by control under § 9-104(a)(3) has priority over a

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93 U.C.C. § 9-327.

94 *See infra* text at notes 99–101.

95 U.C.C. § 9-339.

96 A few secured parties have challenged this conclusion, arguing that the priority rules of U.C.C. § 9-327 only applies to first-generation (original) security interests in the deposit accounts, and not second-generation security interests in proceeds deposited in such accounts. They have hoped that the pre-amendment rules whereby proceeds interests prevailed over other interests survived. As we discuss later, *infra* text at note 110-31, the courts have easily rebuffed these arguments as inconsistent with the language of the provisions. *See, e.g.*, Ky. Highlands Inv. Corp. v. Bank of Corbin, Inc., 217 S.W. 3d. 851, 857 (Ky. Ct. App. 2006).

97 U.C.C. § 9-327 cmt. 4 (emphasis added).

98 *Id.* § 9-327 cmt. 4.

security interest held by the bank with which the deposit account is maintained."[99] A secured party is perfected under U.C.C. §9-104(a)(3) if "the secured party becomes the bank's customer with respect to the deposit account."[100] In other words, assume that bank lends money to *A* who grants it a security interest in its deposit account maintained by Bank B. *A* then wishes to grant a security interest in that deposit account to SP2. For SP2 to have priority over the bank, SP2 would have to cause *A* to transfer the account into SP2's name. Because deposit accounts are contractual, Bank B, however, could refuse to do this thereby protecting itself. Hence, the depositary bank easily avoids subordination to SP2.[101]

4. *The Law of Setoff Under New U.C.C. § 9-340(a)*

The right of a depositary bank with a security interest in the deposit account it maintains is nearly bullet-proof when cash proceeds insinuate themselves into the deposit account. The position of the depositary bank relying solely on the common law right of setoff is not so clear.

Prior to 2000, the bank's setoff right against cash proceeds was anemic. The rule was entirely a judicial creation. Pre-amendment courts either adopted the so-called "legal" or "equitable" rules.[102]

Under the "legal" rule, the bank maintaining the account could not set off against a perfected security interest in identifiable cash proceeds unless it did not know, or have reasonable grounds to know, of the existence of the security interest. If it did have knowledge, the setoff became triangular. That is, the depositary bank owed the proceeds to the secured party, and the debtor owed its loan to the depositary bank. The mutuality of setoff thus was destroyed.

Under the "equitable" rule, the secured party could resist the setoff by a bank without knowledge unless the bank had changed its position in good faith in reliance of the setoff.[103] Although apparently the legal rule was the majority

99 *Id*. § 9-327(4).

100 *Id*. § 9-104(a)(3).

101 Notice that when the depositary bank with control subsequently grants control to SP2, the depositary bank is still senior to SP2. U.C.C. § 9-327(2) ("Except as otherwise provided in paragraphs (3) and (4), security interests perfected by control under Section 9-314 rank according to priority in time of obtaining control").

102 *See* David Gray Carlson, *Commingled Bank Accounts in Bankruptcy*, 28 U.C.C. L. Rev. 267 (1996); Robert J. Skilton, *The Secured Party's Rights in a Debtor's Ban Account Under Article 9 of the Uniform Commercial Code*, 2 S. ILL. U. L.J. 120, 190 (1977).

103 According to Professor Skilton, "The equitable rule derives from the idea that a pre-existing debt does not constitute value, so as to support a bank's set-off against an adverse claim to the fund." *Id*. at 192.

position,[104] we suspect that there was not likely to be much difference in their application as an empirical matter. If a secured party intends to rely on security interests in proceeds, it would almost always notify the bank, putting the bank on actual notice for the purposes of the legal rule.

It is not clear what the current rule is with respect to a bank right of setoff and a proceeds secured interest. U.C.C. § 9-340(a) provides: "Except as otherwise provided in subsection (c), a bank with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account."[105]

Does § 9-340(a) invite banks to expropriate cash proceeds in a setoff? The language of the provision does not say that the bank's right of setoff is *superior* to the proceeds security interest—or indeed to a first-generation security interest in the account. It arguably does not grant the bank any right at all. It merely states that the bank may exercise "any right of recoupment" suggesting that the right, and its limitations, must be established by other law.

This ambiguity is repeated in Official Comment 2 which states, in relevant part:

> This section resolves the conflict between a security interest in a deposit account and the bank's rights of recoupment and set-off.
> . . .
> This section deals with rights of set-off and recoupment that a bank may have under other law. It does not create a right of set-off or recoupment, *nor is it intended to override any limitations or restrictions that other law imposes on the exercise of those rights*.[106]

Does this provision "resolve the conflict," giving priority to the depositary bank? Or does it maintain the status quo?

The scope provisions for Article 9 do little to resolve the matter. U.C.C. § 9-109(d)(10) excludes:

> a right of recoupment or set-off but:

[104] Federal Ins. Co. v. Fifth Third Bank, 867 F.2d 330, 334–35 (6th Cir. 1989); Commercial Discount Corp. v. Milwaukee Western Bank, 214 N.W.2d 33, 37–38 (1974).

[105] U.C.C. § 9-340(a). Subsection (c), similar to U.C.C. § 9-327(4), protects the rights of secured parties who gain control by becoming the deposit account holder. It is not clear whether or how U.C.C. § 9-340 applies to consumer accounts. This subject is beyond the scope of this Article. *See* Steven Walt, *After Article 9: Security Interests and Bank Setoffs in Consumer Deposit Accounts,* 125 BANKING L. J. 224, 225 (2008).

[106] U.C.C. § 9-340 cmt. 2 (emphasis added).

> (A) Section 9-340 applies with respect to the effectiveness of rights of recoupment or set-off against deposit accounts . . . .[107]

Official Comment 14 to U.C.C. §9-109 is once again elusive, stating this exclusion "takes account of new Section 9-340, which regulates the effectiveness of a set-off against a deposit account that stands as collateral."[108] Once again, it is not clear whether these provisions are intended to create a new priority rule for setoffs (which is arguably consistent with the amendment's pro-bank bias), or whether they merely preserve the common law rights of the bank.

Barkley and Barbara Clark, the supreme experts on deposit accounts, maintain that U.C.C. § 9-340 was intended to reverse the common law rule under which secured parties generally prevailed over banks seeking to setoff against deposit accounts. They maintain that the priority rule is "pretty straight forward" and that "there was no issue more contentious than reversing the old priority rule and shifting to a 'depository bank always wins' principle." [109]

Courts have also assumed that U.C.C. § 9-340(a) permits knowledgeable banks to appropriate cash proceeds by means of setoff. The Pennsylvania Supreme Court in *Pioneer Commercial Funding Corp. v. American Financial Mortgage Corp.*[110] so concluded indirectly. The debtor had been an originator of loan portfolios. A secured party would provide interim financing and take a security interest in the portfolios pending sale. Purchasers were to wire the purchase price—proceeds of the original collateral—directly into a deposit account that the secured party maintained for the debtor. On two occasions, purchasers wired funds into a deposit account maintained for the debtor by another bank. The debtor had a substantial overdraft on *this* deposit account because of a check-kiting scheme.[111] As soon as the bank discovered the overdraft, it set off the proceeds deposited in the account against the overdraft.

The Pennsylvania Supreme Court did not directly apply U.C.C. § 9-340(a) because that provision had not yet become effective. Rather, the court determined that Pennsylvania common law permitted the knowing expropriation of cash proceeds through setoff (*i.e.*, it did not adopt *either* the legal or equitable rule). It then noted that this same result had been codified by U.C.C. §9-

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[107] *Id*. § 9-109(d)(10)(A).

[108] *Id*. § 9-109 cmt. 14.

[109] BARKLEY CLARK & BARBARA CLARK, 3 LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS § 18.07 (2018).

[110] *See* Pioneer Com. Funding Corp. v. Am. Fin. Mortg. Corp., 855 A.2d 818, 832 (Pa. 2004).

[111] *Id*. at 823.

340(a).[112] That is, the court read U.C.C. § 9-340(a) as permitting banks to make knowing expropriations through setoff.

A state court of appeals in *Kentucky Highlands Investment Corp. v. Bank of Corbin, Inc.*[113] rejected the claim of a secured party that a bank had converted its cash proceeds by declaring a setoff against a commingled deposit account. In doing so, the court stated that the priorities of secured parties and banks with respect to setoffs were governed by U.C.C. § 9-340. This case, however, is complicated by the fact that the court *also* found that the bank had a security interest in the account perfected by control, so that the priority issue was governed by U.C.C. § 9-327: a depositary bank generally prevails over other secured creditors.[114] In other words, the bank may have been exercising its remedies under its security interest. As we discuss in the next section,[115] the Article 9 remedy for a bank with a security interest in a deposit account it maintained is to set off the secured obligation against the account balance. Consequently, the court's discussion of U.C.C. § 9-340 would seem to be superfluous.

The Eleventh Circuit Court of Appeals in *Eleison Composites, LLC v. Wachovia Bank, N.A.*,[116] applying Georgia law, also upheld a depositary bank's right to exercise a setoff against a perfected security interest in cash proceeds. In *Eleison*, the debtor granted a security interest in all of its assets, including its accounts, payment intangibles, and deposit accounts, to a bank. A buyer agreed to buy all of the failing debtor's assets, including its deposit account, at a deep discount if the bank released its security interest in those assets. The release was executed, so that the buyer bought all accounts receivable. It was understood, however, that debtor's deposit accounts at the bank would "remain open for a short period of time until all of [the debtor's] outstanding checks cleared and all of its outstanding deposits were received."[117] This deposit account soon became overdrawn by approximately $59,000.

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[112] *Id.* at 832.

[113] Kentucky Highlands Inv. Corp. v. Bank of Corbin, Inc., 217 S.W. 3d. 851, 857–58 (Ky Ct. App. 2006).

[114] In doing so, the court correctly held that U.C.C. § 9-327 superseded the pre-amendment case of General Motors Acceptance Corporation v. Lincoln National Bank*,* 18 S.W. 3d. 337 (Ky. 2000) in which the court held that a bank converted the property interest of a secured party when it set off identifiable cash proceeds of a perfected security interest deposited in a deposit account against a debtor's overdrafts. The court noted that, to find otherwise would have allowed an unsecured creditor to leapfrog over the priority rules of Article 9 as they existed prior to the amendments. 18 S.W. 3d. 340. The lower court found that the amendments were intended to change the rules in order to "[shield] depository banks from claims and priority disputes with secured creditors." 855 S.W. 3d. at 854.

[115] *See infra* text at notes 133–35.

[116] Eleison Composites, LLC v. Wachovia Bank, N.A., 267 F. App'x 918, 924 (11th Cir. 2008).

[117] *Id.* at 921.

Almost immediately, an account debtor wired $170,000 into the deposit account which the bank offset against the overdraft. When the buyer tried to withdraw the remaining funds in the account, the bank only transferred the post-setoff balance of approximately $110,000. The buyer demanded the amount of the setoff and, when bank refused, brought a conversion action. The Court of Appeals affirmed a grant of summary judgment for the bank. The court read § 9-340(a) as granting a statutory right of setoff in addition to the contractual, case law and common law of setoff.[118] It did not discuss the language of Official Comment 2 to U.C.C. § 9-340.[119]

In *Bank One, N.A. v. First National Bank*,[120] a district court found that a bank that set off its debt against a commingled deposit account did not convert the assets of the secured party. Although the court did invoke U.C.C. § 9-340 for this proposition, it emphasized that the bank asserting the setoff had no

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118 *Id.* at 924. The court concludes:

> These three statutory provisions govern the effectiveness of setoff rights in deposit accounts, bring the scenario before us expressly within the authority of the U.C.C., and provide that [the bank's] setoff right is superior to any security interest of [the buyer] in [the debtor's] deposited funds.

Id. at 925. According to § 9-109(d)(4), Article 9 does not apply to "a sale of accounts . . . as part of a sale of the business out of which they arose." If this provision applied, then the account debtor's payment of $170,000 would not have been cash proceeds of an Article 9 security interest. In that case, § 9-340(a) would have no jurisdiction. Rather, the common law of setoff would apply to prevent the bank from expropriating the buyer's funds in a setoff.

Nevertheless, in a baffling passage, the court held that "at most, this language suggests that the U.C.C. does not apply to the transaction between [the debtor] and [the buyer], in which the accounts receivable were sold by [the debtor] and purchased by [the buyer]. The section does not exclude, however, a priority dispute between [the bank] and third-party [buyer] as to the funds in [the debtor's] deposit account." Eleison Composites, 267 Fed. Appx at 924. We cannot even begin to make sense of this.

119 In Powell-Perry v. Branch Banking. & Trust Co., 485 Fed. Appx. 403, 407 (11th Cir. 2012), the court assumed that U.C.C. § 9-340(a) invites expropriations of cash proceeds. The case involved a claim that a setoff provision in a bank contract was unconscionable. Perhaps in dictum, the court stated:

> North Carolina banking law allows banks to set off debts owed by the depositor against funds in the account. . . . Because the set-off provision is explicitly permitted by North Carolina law, the set-off provision is not unconscionable.

Powell-Perry, 485 F. Appx at 407 (citing U.C.C. §9-340(a)). For this statement, however, the court relied on Roberts v. First-Citizens Bank & Trust, 478 S.E.2d 809, 812 (N.C. Ct. App. 1996), which arose *before* the adoption of U.C.C. § 9-340(a). The *Roberts* court does state that North Carolina recognized an expropriative common law right of setoff, but found that the bank had waived its rights in that case. In doing so, however, *Roberts* relied on State *ex rel.* Eure v. Lawrence, 378 S.E. 2d 207, 209 (N.C. Ct. App. 1989), which held that a bank's common law right of setoff survived the appointment of a receiver for the customer (but only with respect to funds deposited by the customer, but not to funds deposited by the receiver) and that the bank's continued honoring of checks and deposits post-receivership was not a waiver of its setoff right. This case does not support the view that North Carolina's common law supports an expropriative version of setoff.

120 Bank One, N.A. v. First Nat'l Bank, 2003 U.S. Dist. LEXIS 16369, at *10 (N.D. Tex Sept. 16, 2003).

knowledge of the secured party's financing, despite the fact that the statute does not have a knowledge requirement. Consequently, although the court did not refer to pre-code law, the result is consistent with the majority common law legal rule.

One case cited by the Clarks to support their interpretation of U.C.C. §9-340, *First Dakota National Bank v. First National Bank of Plainview*,[121] is problematic in that is not clear whether the plaintiff ever had a security interest in funds in the deposit account at issue. First Dakota Bank ("FDB") lent money to its customers to purchase livestock to be fed and resold by the debtor, a feed lot operator. FDB would advance funds directly to the debtor who would buy lambs in the name of the customers and then eventually resell them to slaughterhouses. Upon resale, a customer was entitled to receive an amount equal to the original purchase price of the lamb plus a fixed amount. FDB devised this arrangement rather than lending directly to the debtor to purchase livestock himself because it doubted the debtor's financial stability.[122]

The debtor had a commingled deposit account with the First National Bank of Plainview ("Plainview"). Debtor would deposit checks it received from the sale of livestock (along with other deposits) into this account and would pay FDB's customers by drawing checks on the account payable jointly to FDB and the appropriate customer.

Although Plainview originally also financed the debtor's purchase of livestock, because of concerns that, among other things, debtor was engaging in illegal activities, it eventually terminated this arrangement. Nevertheless, the debtor continued using his checking account with Plainview as a de facto line of credit. Plainview continued to honor dozens of debtor checks over seven years allowing him to incur overdrafts on the promise that he would subsequently make new deposits in the account.[123]

Plainview eventually set off the deposit account against the debtor's overdrafts.[124] When the debtor ceased doing business, the customers sued FDB. FDB settled by buying their claims against debtor. It also settled with debtor who had essentially no other assets. It then sued Plainview for conversion of its

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121 First Dakota Nat'l Bank v. First Nat'l Bank of Plainview, 2011 U.S. Dist. LEXIS 106102, at *16–*17 (D.S.D. September 19, 2011).

122 *Id*. at *3.

123 *Id*. at *7–*10.

124 *Id*. at *7–*10. The debtor "owed [FDB] customers over $700,000 and had a negative checking account balance at Plainview of over a quarter million dollars." *Id.*

own and the customers' property, asserting that Plainview knew that proceeds had been deposited in the account.[125]

The district court found for Plainview on the grounds that the U.C.C. § 9-340 superseded the common law of setoffs. A bank exercising its setoff rights always has priority over a secured party that did not perfect by control under U.C.C. § 9-104(a)(3). In fact, neither FDB nor its customers had perfected their rights by filing "a UCC-1, an Effective Financing Statement ('EFS') [or] a caretaker financing statement" against the lambs, let alone by taking control of the deposit account.[126] Instead, FDB merely occasionally requested that Plainview execute "acknowledgments" that FDB "would have a first and paramount security interest in its customers' livestock at [debtor's] feedlot."[127] At some point in time, FDB stopped asking for such acknowledgments "when Plainview said it did not need to do so because Plainview claimed no interest in the livestock on Meyer's feedlot."[128]

The court found that these "acknowledgments" did not constitute a subordination agreement or an agreement not to exercise its setoff right under U.C.C. § 9-341.[129] This part of the opinion seems to be correct if for no other reason than that the "acknowledgments" only referred to any claims that FDB (but not its customers') had in the customers' livestock, but not in the deposit account.

More importantly, although the court asserted that it was "undisputed that [FDB] had a possessory right in the proceeds from the sales of its customer's sheep," it is in fact unclear in this case whether either FDB or the customers had attached security interests in the lambs and their proceeds at all. With respect to FDB, it may not have given value to the debtor and the debtor may not have had

[125] *Id*. at *1–*2. The court had previously denied Plainview's motion for summary judgment on the grounds that under South Dakota had adopted what we are calling the legal rule with respect to setoffs and there were questions as to Plainview's knowledge.

[126] *Id*. at *4–*5. The court thought that filing financing statements would have prevented the conflict because the slaughterhouses, as buyers, would have been "on notice that when the [lambs] were sold, the buyers needed to include [FDB's] name or its customer's name on the check as a payee." *Id.* Apparently, "[FDB] believed that the way [debtor] did business—*i.e.*, without any financing statements of any type filed against him—allowed him to get better contractual terms from the slaughter houses." *Id.* at 13.

[127] *Id*. at *5.

[128] First Dakota Nat'l Bank v. First Nat'l Bank of Plainview, 2010 U.S. Dist. LEXIS 61898, at *3 (D.S.D. June 22, 2010). This is also the reason given as to why FDB did not believe it was necessary for it to file financing statements. First Dakota Nat'l Bank, 2010 U.S. Dist. LEXIS 61898, at *2. This is despite the fact that the court recites that Plainview had "a blanket security agreement in [the debtor's] personal property." First Dakota Nat'l Bank, 2010 U.S. Dist. LEXIS 61898, at *1.

[129] First Nat'l Bank of Plainview, 2011 U.S. Dist. LEXIS 106102, at *27–29.

rights in the collateral for the purposes of U.C.C. § 9-203(b) because FDB lent money to its customers who were the owners of the lambs. Even if this transaction were deemed to be value to the debtor, in the sense that it did benefit him, he did not owe money to FDB so there was no secured obligation. At most, the security interest could only attach in the debtor's interest in the lambs, which was not ownership but the mere temporary possessory right of a bailee. Moreover, there is no indication that the debtor ever authenticated a security agreement granting a security interest to FDB. Indeed, when asked why FDB did not file a financing statement against the debtor, one of its officers testified that "[i]t could have been an unsecured credit relationship."[130]

With respect to the customers, this arrangement seems to have constituted a consignment under U.C.C. § 9-102(a)(20). Under amended Article 9,[131] a consignment is a security interest and a consignor is a secured party. Consequently, the customers had to comply with U.C.C. § 9-203 in order for its rights as consignors to attach and become enforceable. Once again, there is no indication in the case that the debtor authenticated security agreements in favor of the customers. If not, then the customers' consignment-security interest never attached, in which case there never was a priority dispute between FDB and its customers, on the one side, and Plainview, on the other.[132]

In any event, as an empirical matter, it is unlikely that many occasions will arise to test the meaning of U.C.C. § 9-340(a). Now that the U.C.C. allows banks to take superpriority security interests in the deposit accounts they maintain, we can expect that all standard form deposit account agreements will contain boilerplate granting the bank a security interest.[133] Accordingly, in a future priority dispute, the bank will rest on its rights as a secured party, not on its setoff rights.

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[130] *Id*. at *5.

[131] U.C.C. § 9-109(a)(4).

[132] We would also point out that the cases that the *Plainview* court cited in favor of the proposition that Article 9 supersedes the common law of setoffs are inapposite in that they do not involve a bank's right to set off against deposit accounts it maintains. For example, both Rushmore State Bank v. Kurylas, Inc., 424 N.W.2d 649 (S.D. 1988), and In re Apex Oil Co., 975 F.2d 1365 (8th Cir. 1992), involve the application of old U.C.C. § 9-318, the predecessor of current U.C.C. § 9-404, which governs the right of an account debtor to assert defenses (including setoffs, which the U.C.C. now calls "claims in recoupment) of an account debtor against an assignee of an account. A third cited case, Consolidated Nutrition, L.C. v. IBP, Inc., 2003 SD 107, 669 N.W.2d 126 (S.D. 2003), is a plain vanilla priority dispute between a secured party and a purchaser of a general intangible.

[133] *See* Markell, *supra* note 90, at 1007.

5. *Remedies*

What are the rights of a depositary bank under its security interest on the depositary account it maintains for the debtor? Pursuant to U.C.C. § 9-607(a)(4), upon default, if the depositary bank "holds a security interest in a deposit account perfected by control under Section 9-104(a)(1), [it] may apply the balance of the deposit account to the obligation secured by the deposit account." That is, it has the right to *set off the account*.

It is illuminating that the depositary bank's only remedy for its perfected security interest in the account that it maintains is, basically, the right of setoff. The traditional remedies given by Part 6 of Article 9 are collection from the account debtor[134] and sale of the asset.[135] These do not remotely work for the depositary bank, in that its own duty to perform *is* the collateral. There is no third party from which the bank could collect. It cannot collect from itself because, after this fruitless gesture is accomplished, the debtor's obligation remains undischarged. And selling the deposit account to a buyer is a wash. Sale does not serve to pay the secured claim. To our knowledge, the original security interest of a depositary bank in the deposit account it maintains is the only one in which neither collection nor sale of the collateral function.

6. *Priority Against Persons Who Become Lien Creditors*

Despite the fact that the power of a bank to take a security interest in deposit accounts it maintains is now well established, some courts still manifest confusion as to the rights of the depositary bank vis à vis judgment lien creditors of the customer. This confusion seems to spring from a basic ignorance of what it means to take a security interest in a deposit account. Coupled with this ignorance is a misreading of a leading Eighth Circuit case and a failure to distinguish between security interests taken by the bank that maintains the deposit account as opposed to security interests taken by a secured party in a deposit account maintained by a third-party bank.

In two cases, *American Home Assurance Co. v. Weaver Aggregate Transportation, Inc.*,[136] and *S.E.I.U. Local No. 4 Pension Fund v. Pinnacle Health Care of Berwyn LLC*,[137] the courts, purporting to apply Illinois law, held

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[134] U.C.C. § 9-607(a).
[135] *Id*. §§ 9-609, 9-610.
[136] American Home Assurance Co. v. Weaver Aggregate Transp., Inc., 84 F. Supp. 3d 1314, 1327 (M.D. Fla. 2015).
[137] S.E.I.U. Local No. 4 Pension Fund v. Pinnacle Health Care of Berwyn LLC, 560 F. Supp. 2d 647, 651 (N.D. Ill. 2008).

that a bank with a perfected security interest in deposit accounts it maintained could not set off its obligation in order to prevent garnishment by lien creditors because they had not taken any acts to enforce their secured claim before the garnishment. Indeed, the court in *Weaver* makes an extraordinary statement in contradiction to the very theme of U.C.C. §9-317(a): "Circuit courts have rejected banks' arguments that a perfected security interest automatically gave them priority over a judgment creditor."[138] In subordinating the bank's security interest, both courts claimed to rely on the Eighth Circuit's holding in *Frierson v. United Farm Agency, Inc*.[139] In fact, *Frierson* is very distinguishable.[140]

In the correctly decided *Frierson* case, a bank had perfected security interests in three deposit accounts: one that it maintained for the debtor and two others maintained for the debtor by other banks.[141] Because this case arose before the 2000 Amendments to Article 9, it would seem that the deposit accounts constituted cash proceeds of other collateral and were perfected by filing, although the court does not expressly say so.

With respect to the account it maintained, the court held that, applying Missouri law, the bank could exercise its right of setoff vis à vis the lien creditor. Although a setoff cannot formally be manifested before the debt becomes mature, the setoff opportunity constitutes a condition on the garnishee's obligation to pay the lien creditor, and the lien creditor is subject to the bank's senior right of setoff[142]—a standard common law holding.[143]

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138 American Home Assurance, 84 F. Supp. 3d at 1326.

139 Frierson v. United Farm Agency, Inc., 868 F.2d 302 (8th Cir. 1989).

140 These two courts also misinterpreted the language of the security agreements. Both security agreements contained boilerplate language that, upon default, the secured party has the rights of a secured creditor. We have seen similar language in dozens of security agreements. It is typically a lead-in to the remedies section of the security agreement which then spells out in detail what those rights are. Nevertheless, these courts read this provision as saying that the banks did not have rights of secured parties until default! American Home Assurance, 84 F. Supp. 3d at 1325–26; S.E.I.U. Local No. 4 Pension Fund, 560 F. Supp. 2d at 650. It is hard to imagine how the parties to a security agreement could intend such an interpretation because the effect would be, as these cases illustrate, that the secured party's rights would often vest too late to be useful. *See* Allegaert v. Chemical Bank, 657 F.2d 495 (2d Cir. 1980) (rejecting such an interpretation of a similar clause).

Despite this, another court would agree that the *Pinnacle* court's reading was the "plain language" of the security agreement. One CW, LLC v. Cartridge World N. Am., LLC, 661 F. Supp. 2d 931 (N.D. Ill. 2009). This case quoted the language of the security agreement in full. More relevant to the application of the security agreement that, "*[u]ntil default* . . . Grantor may have . . . beneficial use of all the Collateral and may use it in any lawful manner not inconsistent with this Agreement . . ." One CW, LLC v. Cartridge World N. Am., LLC, 661 F. Supp. 2d at 934 (emphasis in original). The court found that, although the bank did call a default, it did not take consistent action to enforce it. Consequently, the judgment debtor could garnish the funds because the debtor still had the right to them.

141 Frierson v. United Farm Agency, Inc., 868 F.2d 302 (8th Cir. 1989).

142 *Id.* at 304.

143 One sees this rule reflected in U.C.C. § 9-404(a), which states that

With respect to the accounts maintained by other banks, the court considered the familiar problem of whether a senior secured creditor who had not yet taken action to enforce its security interest could prevent a junior secured creditor from exercising its rights. The court rightly found that it could not.[144] Yet it was equally true that:

> [r]egardless of whether the funds in question are viewed as collateral or as proceeds, Article 9 requires that [the lien creditor] take the remaining funds subject to [the secured party's] security interest if the bank refuses to exercise its remedies under the code. § 400.9-306(2). [The secured party's] security interest in the funds will continue, and [the secured party] can trace and recapture when it chooses to declare the loan in default and accelerate the debt.[145]

Though analytically correct, this may seem odd. The lien creditor (acting through the sheriff, of course) is entitled to take possession of assets encumbered by a senior security interest. Yet the secured party has a senior right of possession and can dispossess the lien creditor—a principle that applies to cash proceeds as well as other kinds of collateral. The Eighth Circuit seemed to be saying that the garnished banks (including the bank that is the secured party) must pay the funds in the deposit accounts they maintain to the judgment creditor *now*, but as soon as default under the senior security agreement occurs, the judgment creditor must surrender all amounts back to the senior secured party. In any event, this result, correct though odd, contradicts the results reached in the *Weaver* and *Pinnacle* cases.

The Eighth Circuit in *Frierson* rightly noted that a bank's setoff rights with respect to the deposit account it maintains are different from its rights as a secured party in deposit accounts at third party banks. This is fair enough under both old and new Article 9. The Eighth Circuit also rightly distinguished the question whether a lien creditor may garnish a bank account if a secured party had not yet declared a default (yes) as one that was entirely distinct from the question of who, between the garnishor and the secured party, has a prior possessory right to the funds garnished.[146]

> the rights of the assignee are subject to . . .
>
> (2) any . . . claim of the account debtor against the assignor which accrues before the account debtor receives a notification of the assignment authenticated by the assignor or assignee . . .

[144] Frierson, 868 F.2d at 304–05.

[145] *Id.* at 305.

[146] In Martens v. Hadley Memorial Hosp, 729 F. Supp. 1391, 1396 (D.D.C. 1990), another pre-2000 case, the court purported to follow *Frierson* in holding that a mere declaration of default by a secured party does not prevent a creditor enforcing its lien against a deposit account, if the secured party had not yet taken remedial

Both these points were overlooked in *One CW, LLC v. Cartridge World North America, LLC*,[147] where a lien creditor arranged for the garnishment of a deposit account maintained by the secured party bank for its customer. The bank declared a default and froze the account but later permitted the debtor to withdraw funds from the account. Although the *Cartridge* court acknowledged that the secured party had priority over the judgment creditor in cash proceeds, it required the bank to pay the garnishor amounts equivalent to the debtor's post-garnishment withdrawals. The bank, the court remarked:

> has not taken consistent actions pursuant to its rights and remedies resulting from [the debtor's] default. Most importantly [it] only froze [the debtor's] assets for five days before allowing [the debtor] to resume unencumbered use of the account. . . . Having failed to pursue its rights under the security agreement, [the secured party] cannot now object to [the judgment creditor's] demand for those funds.[148]

The *Cartridge* court indicated that, when the bank first received the writ of garnishment, it could have exercised its right by freezing the account. It not only failed to do so, but it failed to answer the garnishor's interrogatories and it extended a secured loan by permitting the debtor access to the bank's cash collateral.

The result overlooks the fact that the funds that the secured party bank permitted the debtor to withdraw were, in fact, the secured party's money, which it had the right to dispose of as it wished. The bank was not waiving its senior security interest in the proceeds of the deposit account. At best, the garnishor had a lien on the debtor's *valueless equity* in the cash proceeds. If the bank wrongfully interfered with the garnishor's rights, the damage to the garnishor was zero, because the value of the debtor equity was zero.[149]

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action. Nevertheless, as in *Frierson,* the court found that the bank's right of set-off was superior to the lien and quashed the garnishment. The secured party did not, however, have a right of set-off with respect to a second debtor account that was held in trust for another party.

[147] One CW, LLC v. Cartridge World N. Am., LLC, 661 F. Supp. 2d 931 (N.D. Ill. 2009). Apparently, the secured party took and perfected its security interest between the time the creditor obtained its judgment against the debtor, but before it obtained a judgment lien or garnished the secured party. The court found that in doing so the bank did not violate a duty of good faith to the creditor. *Id.* at 938. This court also approved of the *Pinnacle* court's egregious misreading of the virtually identical boilerplate remedies provision discussed *supra* in note 140 as "plain language" but distinguished the cases on the facts. One CW, LLC, 661 F. Supp. 2d at 934–35.

[148] One CW, LLC, 661 F. Supp. 2d. at 935.

[149] *See* David Gray Carlson, *Security Interests in the Crucible of Voidable Preference Law*, 1995 U. ILL. L. REV. 211, 274–75 (1995) (making this point in the context of voidable preference law).

Furthermore, whereas Article 9 accords to secured parties an automatic proceeds security interest in collateral,[150] there is no similar principle to benefit garnishors under Illinois law. Thus, the funds while embodied in the positive balance of the deposit account were proceeds that belonged to the bank as secured party. These funds withdrawn by debtor from the account with authority from the bank continued to be proceeds. The debtor presumably spent these funds, in which case, anything that the debtor purchased with the funds would be proceeds of proceeds that also belonged to the bank.[151] Whereas the bank's security interest follows the chain of proceeds, the garnishor's judicial lien does not. The cash advanced by the bank and the avails of that cash are entirely free of the garnishor's judicial lien which would never attach to the proceeds of the garnished account.

These points were recognized in *Myers v. Christenen,*[152] where the debtor had granted an original collateral security interest to the bank in its deposit account maintained by the same bank. The secured party did not turn over funds to a garnishing judgment creditor, permitting the debtor to continue to withdraw funds until it was overdrawn and eventually went out of business.

Whereas the lower court found that the bank had lost its right under what we call the "use-it-or-lose-it" principle, the Nebraska Supreme Court overruled the lower court on the grounds that the bank was not exercising its set-off rights, but its rights as a perfected secured party.[153] Furthermore, the secured party made a conscious decision that its best chance to receive payment in full would be for the debtor to succeed in its business.[154] Because a garnishor's rights cannot exceed those of the debtor, and the secured party had the right to enforce its security interest in the deposit account, its rights were prior to the judgment creditor. The court expressly noted that to find otherwise "would ignore and indeed negate the statutory priority to which a holder of a prior perfected security interest is entitled."[155] In support of its decision the court noted that at the time of the garnishment the debtor was in default, and the amount of its secured obligation was much greater than the balance in the deposit account. Moreover,

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150 U.C.C. § 9-315(a)(2).

151 Of course, under U.C.C. § 9-315(d), the automatic perfection of the security interest in these proceeds-of-proceeds would lapse after 20 days unless the secured party has filed a financing statement containing an adequate description of the proceeds since they will be proceeds acquired with cash proceeds. *See supra* text accompanying notes 85–86.

152 Myers v. Christensen, 776 N.W.2d 201, 203 (Neb. 2009).

153 *Id.* at 206–07.

154 *Id.* at 203–04.

155 *Id.* at 206–07

the bank did not waive its rights as a secured creditor by allowing the debtor to withdraw money.[156]

A secured party bank prevailed on similar facts in *Fifth Third Bank v. Peoples National Bank*.[157] The trial court held that the bank had waived its security interest by untruthfully answering the garnishing lien creditor's interrogatories, having stated that bank did not have any of the debtors assets.[158] An appellate court reversed on the grounds that the bank's perfected security interest was prior to the judgment lien.[159] The court also held that Indiana adopted the majority rule that a depositary bank may exercise its right of set-off even after receiving a notice of garnishment.[160] The court rejected the lien creditor's argument that the secured party had waived its rights by allowing the debtor to withdraw funds, noting that U.C.C. § 9-104(b) expressly provides that "a secured party's decision to allow the debtor to reach the funds in its deposit account is not inconsistent with control."[161] Once again, the amount of the secured obligation was much greater than the amount of funds in the account at the time of garnishment. Nevertheless, the court agreed with the trial court's findings that the bank should be sanctioned for its inappropriate actions during discovery and remanded to determine appropriate sanctions.

In *Joseph Stephens & Co. v. Cikanek*[162] the District Court for the Northern District of Illinois, applying New York law, similarly refused to grant a turnover order against a bank having a security interest in a deposit account it maintained. The court correctly noted that under the priority rule of U.C.C. § 9-317(a)(2)(A) a security interest is only subordinate to an entity that became a lien creditor before perfection.[163] It particularly relied on Comment 4 to U.C.C. § 9-327 for the proposition that "[t]he drafters of the U.C.C. intended this rule—automatic priority in favor of depository banks—to alleviate concerns that judgment creditors or other secured parties could deplete deposit accounts and thus 'impede the flow of funds through the payment system'."[164]

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156 *Id.* at 206–07.

157 Fifth Third Bank v. Peoples Nat. Bank, 929 N.E.2d 210 (Ind. Ct. App. 2010).

158 *Id.* at 213.

159 *Id.* at 215.

160 *Id.* at 214 (citing Farmers State Bank of Mentone, Inc. v. United States Internal Revenue Service, 22 F. Supp. 2d 892, 895 (N.D. Ind. 1998)).

161 Fifth Third Bank, 929 N.E.2d at 216 (citing IC § 26-1-9.1-104 cmt. 3) (internal quotation marks omitted).

162 Joseph Stephens & Co. v. Cikanek, 588 F. Supp. 2d 870, 876 (N.D. Ill. 2008).

163 *Id.* at 874.

164 *Id.* at 875–76.

The errors made in *Weaver* and *Pinnacle* are much magnified if they are exported to the context of bankruptcy, where the trustee is a hypothetical judicial lien creditor on the day of the bankruptcy petition. If *Weaver* and *Pinnacle* are correct, then a secured party bank's security interest in bankruptcy would be inherently inferior to the trustee's strong arm power. In that case, secured party banks would be reduced to their common law right of setoff.

Happily, both these cases are *Erie* guesses by federal courts as to the content of state law and thus subordinate to the better *Erie* guesses of the highly expert bankruptcy court.

7. *The Challenge of U.C.C. § 9-332(b)*

We scrutinize another threat to a bank's security interest in the account it maintains for the debtor. The worth of such a security interest would be dealt a crushing blow if a bankruptcy trustee were to be considered a transferee for the purposes of U.C.C. § 9-332(b), according to which:

> A transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party.[165]

We have seen that old Article 9 declined to govern security interests in deposit accounts as original collateral, but it governed second-generation cash proceeds that were deposited in bank accounts. Suppose a debtor issued a check that caused the depositary bank to pay some of the cash proceeds to some third-party payee on a check. Could the secured party claim that the payee had tortiously converted the secured party's cash collateral?

Embarrassingly, old Article 9 had no rule on this fundamental question, but Comment 2(c) to old § 9-306 provided:

> 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.

The "of course" phrase in the Comment virtually confesses that original Article 9 badly fumbled in not providing a direct rule on the question. In any case, courts learned to raise Comment 2(c) to statutory dignity in applying it as the governing rule.[166]

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[165] U.C.C. § 9-332(a) contains an almost identical rule protecting a transferee of "money."

[166] *Accord,* Brown & Williamson Tobacco Corp. v. First Nat'l Bank, 504 F.2d 998, 1002 (7th Cir. 1974);

The introduction in 2000 of first-generation security interests in deposit accounts exacerbated the concern that security interests (whether first- or second-generation) would interfere with the primary function of deposit accounts—namely to act as money. If this security interest followed funds out of the deposit account, "money" (broadly conceived) would cease to be negotiable. Although the U.C.C. defines money as physical currency such as notes and coins,[167] within the United States, the vast majority of money for economic and regulatory purposes consists of deposit accounts.[168]

Consequently, the drafters added U.C.C. § 9-332(b), a super-negotiability rule based on the rules earlier conceived with regard to "securities entitlements" under U.C.C. Article 8.[169] These rules go beyond quotidian protection of bona fide purchasers for value. "Transferees" are protected. "Transferee" is a broader term than "purchaser." "Purchaser" implies a *voluntary* transfer,[170] whereas "transferee" includes *involuntary* transfers.

A setoff right in a deposit account is subject to the rule of "use-it-or-lose-it", while an Article 9 security interest in a deposit account invokes a "chain of proceeds" concept.[171] If the depositary bank has a security interest in the account it maintains for its customer, a thing bought with the funds paid out of a deposit account is encumbered by a proceeds security interest (perhaps only temporarily

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see Markell, *supra*, note 90 at 992.

[167] Although the definition of money in U.C.C. § 1-201(b)(24) as "a medium of exchange currently authorized or adopted by a domestic or foreign government" does not contain an express reference to tangibility, a careful reading of all of the provisions in the U.C.C. that use the term reveal that it is limited to money that can be possessed and that the term "possession" in the U.C.C. is limited to the fact of physical possession. This can also be seen in the contrast between how the U.C.C. treats "deposit accounts," which are not money, and its contrast of the defined term "control" with "possession." The fact that the drafters found it necessary to write separate rules for "money," U.C.C. § 9-332(a), and for deposit accounts, U.C.C. § 9-332(b), is further evidence that the defined term "money" in Article 9 is limited to hand-to-hand money. For full analysis, Schroeder, *Bitcoin,* supra note 92, at 19–29.

[168] U.C.C. § 9-332 cmt. 3. The basic measurement of money adopted by the Federal Reserve Bank is M1, which consists of hand-to-hand money (i.e. M0) plus checking and similar liquid accounts. Although M1 tends to be split roughly half and half between hand-to-hand money and demand accounts, this is because physical U.S. currency serves as the de facto currency in much of the world. *Money Stock Measures*, Federal Reserve Statistical Release H.6, https://www.federalreserve.gov/RELEASES/h6/Current/default.htm. The majority of physical U.S. currency is held abroad; within the United States, however, most M1 consists of deposit accounts. Federal Reserve Bank of New York, *How Currency Gets in Circulation* http://www.newyorkfed.org/aboutthefed/fedpoint/fed01.html.

[169] U.C.C. § 8-503(e). This provision is somewhat narrower than U.C.C. § 9-332(b) in that it only protects "purchasers", rather than "transferees". For a discussion of the 1994 amendments to Article 8 that introduced this concept see Jeanne L. Schroeder, *Is Article 8 Finally Ready This Time? The Radical Reform of Secured Lending on Wall Street*, 1994 COLUM. BUS. L. REV. 291 (1994).

[170] U.C.C. § 1-201(b)(29) ("'Purchase' . . . means . . . voluntary transaction creating an interest in property").

[171] *Id.* § 9-315(a)(2).

perfected).[172] The funds paid out by the bank, however, are free of the security interest. Is it strange that the funds should be free and clear but the thing bought is encumbered? This is no more an anomaly than the traditional rule that, although a buyer in the ordinary course of encumbered goods takes free of a security interest in the goods,[173] anything the debtor receives upon that disposition is subject to a proceeds security interest.[174]

Under U.C.C. § 9-332(b), a non-colluding transferee from the encumbered deposit account takes free of any security interest. In contrast, a debtor's withdrawal does not destroy the security interest in the funds.[175] U.C.C. § 9-332(b) refers to disencumbrance in favor of *transferees.* The debtor is no transferee. If this were not so, the security interest in the deposit account is worth little.

The policy behind U.C.C. § 9-332(b) is "to ensure that security interests in deposit accounts do not impair the free flow of funds."[176] This policy applies equally to original security interests in deposit accounts and to proceeds. Indeed, Official Comment 3 refers expressly to security interests in proceeds deposited in deposit accounts.[177]

Nevertheless, the Fifth Circuit Court of Appeals, in *Garner v. Knoll, Inc. (In re Tusa-Expo Holdings, Inc.)*,[178] has stated that § 9-332(b) has no effect on proceeds security interests; rather, it affects only original collateral security interests:

> It is clear to us that § 9.332(b) ensures that the funds in a deposit account remain unencumbered by a security interest in the deposit account itself. Section 9.332(b) does not even address, must less strip,

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[172] *Id*. § 9-315(d) (preamble).

[173] *Id*. § 9-320(a) (". . . a buyer in the ordinary course of business . . . takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence").

[174] *Id*. § 9-315(2) ("a security interest attaches to any identifiable proceeds of the collateral").

[175] As Official Comment 2 to U.C.C. § 9-332(b) confirms:

> The word "transferee" is not defined; however, the debtor itself is not a transferee. Thus this section does not cover the case where a debtor withdraws money (currency) from its deposit account or the case in which a bank debits an encumbered account and credits another account it maintains for the debtor.

U.C.C. § 9-332(b) cmt. 2.

[176] *Id*. § 9-332(b) cmt. 3.

[177] As noted in City Bank v. Compass Bank, 717 F. Supp. 2d 599 (W.D. Tex. 2010); *see also* Keybank Nat'l Ass'n v. Ruiz Food Prods., 2005 U.S. Dist. LEXIS 48262 (D. Idaho Sept. 9, 2005).

[178] *In re* Tusa-Expo Holdings, Inc., 811 F.3d 786 (5th Cir. 2016).

> a security interest that encumbers the funds contained in the deposit account.[179]

Consequently, a creditor's security interest in proceeds deposited in a deposited account continued in funds transferred to a third party.

In arriving at this disturbing interpretation, the *Garner* court makes much of the fact that the language of U.C.C. § 9-332(b) differs from that of U.C.C. § 9-332(a), which disencumbered a non-collusive transfer of money from a security interest:

> The plain language of § 9.332(b) states that a "transferee of funds from a deposit account takes the funds free of a security interest *in the deposit account*." Although § 9.332(a)—which applies to transfers of "money"—and § 9.332(b)—which applies to transfers of "funds"—are similar, they are not identical. Specifically, § 9.332(a) provides that "[a] transferee of money takes the money free of *a [read: any] security* interest." By contrast, § 9.332(b) provides that "[a] transferee of funds from a deposit account takes the funds free of *a security interest in the deposit account* . . . ." This difference must have been intentional. The drafters could have specified, but did not, that "a transferee of funds from a deposit account takes the funds free of a [*read:* any] security interest" as they did in § 9.332(a). Or they could have specified that "a transferee of funds from a deposit account."[180]

The crux of the court's interpretation is that a security interest in cash proceeds deposited with the bank is not a "security interest in the deposit account." But this is not so. The deposit account is the bank's promise to pay the customer on demand. When the customer deposits a secured party's cash, the bank takes title to the cash and promises the customer to repay on demand. The bank's promise

[179] *Id.* at 796. The *Garner* court cites Madisonville State Bank v. Canterbury, Stuber, Elder, Gooch & Surratt, P.C., 209 S.W.3d 254 (Tex. App. 2006), as holding that the lien-stripping provisions of U.C.C. § 9-332(b) do not apply to security interests in deposited proceeds. In fact, it is not clear what the *Madisonville* court thought it was doing in this confusing case. A secured party claiming deposited cash proceeds brought a conversion action against a payee of a check drawn on that deposit account. The payee moved for summary judgment on the basis of U.C.C. § 9-332(b). The secured party responded that § 9-332(b) only applies to original collateral security interests in deposit accounts, not to proceeds security interests. Agreeing with this, the court found that a security interest in a deposit account can only be perfected by control, and there was no evidence that the secured party had control. Accordingly, the payee "failed to establish as a matter of law that section 9.332 governed this situation" and its motion for summary judgment was dismissed. Thus, the court implied that § 9-332(b) applied only to *perfected* original collateral security interest in deposited accounts and that a payee would not take free of an *unperfected* security interest in a deposit account. In other words, the unperfected security interest in the deposit account was seen as more powerful than the perfected version. The court also ignored the fact that under U.C.C. § 9-315(d)(2) security interests in deposited cash proceeds *may* be perfected by filing as to the original collateral.

[180] *In re* Tusa-Expo Holdings, Inc., 811 F.3d at 795–96 (footnotes omitted) (emphasis in original).

to repay on demand is proceeds of the encumbered cash, and the promise to repay *is* the deposit account. Therefore, the secured party has a security interest in the bank's promise. The promise *is* the deposit account. So, the secured party has a security interest "in the deposit account."

In his blistering criticism of the *Garner* case, Professor Thomas Plank suggests that the *Garner* court evinces a fundamental misunderstanding of the nature of deposit accounts, one that could be avoided if the U.C.C. were amended to provide new terminology.[181] Although we agree that, in retrospect, the language in § 9-332(b) might have been clearer, and believe that the *Garner* misinterpreted the section, it is not apparent to us that the court does not understand deposit accounts. Rather, it is because the court (mistakenly) believed § 9-332(b) was restricted to the *new* "control" security interest on deposit accounts, not a restriction on security interests in deposited cash proceeds generally.

Although the *Garner* court's interpretation of § 9-332(b) is egregious, nevertheless the outcome of the case is correct, but not for the reasons stated by the Fifth Circuit. Indeed, U.C.C. § 9-332(b) is completely irrelevant to the proper resolution of this case. The case did not turn on whether a transferee took funds free and clear of another creditor's claim to proceeds, but on whether the recipient of the funds was receiving proceeds of its own security interest. We argue that the result of *Garner* is correct for the reasons awkwardly set forth in the bankruptcy court opinion.[182]

In *Garner*, the debtor ("D") was a distributor for a furniture manufacturer ("SP1"). D would buy furniture on credit from SP1, secured by all of D's assets including its accounts. When D's business faltered, SP2 entered the picture to provide additional credit in the form of a revolving credit facility ("the revolver") which was also secured by all of D's assets. SP1 agreed to subordinate its security interest to SP2, carving out only three accounts in which SP1 maintained its priority.

Under the revolver, all proceeds of D's accounts were deposited into a "lock-box," *i.e.*, a dedicated deposit account maintained by a bank over which SP2 had control. Consequently, SP2's security interest in the proceeds deposited in the lock-box were prior to SP1's for two reasons: SP1 subordinated itself by

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181 Thomas E. Plank, *Security Interests in Deposit Accounts, Securities Accounts, and Commodity Accounts: Correcting Article 9's Confusion of Contract and Property*, 69 OKLA L. REV. 339, 354 (2017).

182 Tusa-Expo Holdings, Inc. v. Knoll, Inc., 496 B.R. 388 (Bankr. N.D. Tex. 2013).

agreement, and U.C.C. § 9-327(1) privileges SP2's perfection by control over SP1's perfection by filing.

Every day, SP2 would "sweep" the lock-box, withdrawing all funds, and applying them towards repayment of D's indebtedness to SP2. D would then, from time to time, request that SP2 advance funds under the revolver to pay its expenses and other creditors, including SP1. SP2 made such advances by making deposits into D's general operating deposit account. D used part of these funds to repay its indebtedness to SP1.

Upon D's bankruptcy, D's trustee brought a motion to recover all payments made to SP1 within ninety days of bankruptcy on the grounds that (i) the payments made out of the general operating funds were voidable preferences under § 547(b); and (ii) the payments out of the account owed by SP1 to D were improper setoffs under § 533.

The bankruptcy court held that the first payments were not preferences for two reasons. First, the element of § 547(b)(5) was not met: the payments did not enable the creditor to receive more than it would have in a chapter 7 bankruptcy. The payments were traceable proceeds of SP1's junior perfected security interest in the accounts D paid into the lock-box. Admittedly SP1's claim was "under-water"—the aggregate amount of the claims by SP1 and SP2 against the collateral exceeded the value of the collateral. When an undersecured creditor receives *unencumbered* dollars, the payment always meets the § 547(b)(5) test.[183] But when an undersecured creditor takes possession of cash proceeds, there is no preference. Therefore, the trustee's case for voidable preference was defeated. Second, the transfers fell within the exception of § 547(c)(5) which protects after acquired security interests in accounts if the secured creditor's net position is not improved during the preference period.[184]

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[183] Carlson, *Crucible*, *supra* note 149, at 269–75.

[184] Tusa-Expo Holdings, Inc. v. Knoll, Inc., 496 B.R. 388, 406 (Bankr. N.D. Tex. 2013). The district court for the Northern District upheld the bankruptcy court's opinion. Garner v. Knoll, Inc. (*In re* Tusa-Expo Holdings, Inc.), 2015 U.S. Dist. LEXIS 26468 (N.D. Tex. Mar. 4, 2014).

SP1 had retained D to perform design and installation services in connection with a large project in connection with a major bank's renovation of its corporate offices. D granted SP1 a security interest in its rights against SP1 under this contract. That is, SP1 was taking a security interest in its own obligation to D under an account, much like the U.C.C. now recognizes that a bank can take a security interest in its own obligation to its customer under a deposit account. *See supra* text accompanying notes 74–82. Whenever SP1 received a payment from its customer, SP1 would make a payment on its account owed to D by crediting the amount towards repayment of D's debt to SP1.

D's trustee argued that these payments to D were improper setoffs under § 553. The bankruptcy court found that under § 553(b)(1) the trustee may only disallow a setoff only "to the extent that any insufficiency on the date of such setoff is less than the insufficiency" on the appropriate measuring date. Applying this test the

The bankruptcy court's analysis was correct. To understand this, let us offer a simpler hypothetical that replicates the logic of the holding.[185] Two creditors, A (senior) and B (junior) each have a secured claim of $100,000 in accounts and in $50,000 of cash proceeds deposited in a lock-box deposit account. Total claims are $200,000 against collateral worth $150,000. A is oversecured and B is undersecured. In a liquidation, A would be paid $100,000 and B would be paid $50,000.[186] As in *Garner,* A's security agreement has a future advance[187] and an after acquired property clause.[188]

On Day Two, A sweeps the lock-box and applies the $50,000 towards payment of its secured claim, reducing A's claim to $50,000. A is still oversecured for its $50,000 claim, because it has priority to the $100,000 in uncollected accounts. B's secured claim remains at $100,000. B is still undersecured. B's junior position in the collateral is valued at $50,000. B was neither helped nor harmed when A applied the cash proceeds to A's secured claim.

On Day Three, upon D's request, A advances $20,000 to D under its revolver by depositing this amount in D's general operating deposit account (*i.e.*, not the lock-box). As a result, A now claims $70,000 against $100,000 in uncollected accounts. The advance reduces B's security interest in the same accounts from $50,000 to $30,000 because A's advance is senior to B's junior security interest.[189]

D now has $20,000 in its general operating account. We maintain that B has a security interest in these funds, because these funds are cash proceeds of the uncollected accounts. Proceeds include "whatever is acquired upon . . . the

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court found that only approximately $105,000 of the six offsets made by SP1 were impermissible and recoverable. 496 B.R. at 409–10.

185 We set forth our analysis in greater detail in Jeanne L. Schroeder & David Gray Carlson, *Loan Proceeds and Article 9 Proceeds,* 48 U.C.C. L.J. 155 (2018).

186 Before unsecured creditors are paid, A and B would obtain the collateral under Bankruptcy Code § 725, which provides:

> After the commencement of a case under this chapter, but before final distribution of property of the estate under section 726 of this title, the trustee, after notice and a hearing, shall dispose of any property in which an entity other than the estate has an interest, such as a lien, and that has not been disposed of under another section of this title.

If there is a junior tax lien on the collateral, A and B receive their collateral under § 724(b)(1).

187 U.C.C. § 9-204(c) ("A security agreement may provide that collateral secures . . . future advances or other value, whether or not the advances or value are given pursuant to commitment").

188 *Id.* § 9-204(a) ("a security agreement may create or provide for a security interest in after-acquired collateral").

189 *Id.* § 9-322(a)(1).

disposition of collateral."[190] A's advance to D was a disposition of B's collateral, and as a result B has "cash proceeds."[191]

On Day Four, D writes a check payable to B on the general operating account. When B's check clears, B is receiving B's own cash proceeds.[192] Foreclosing on proceeds can never be a voidable preference, because the foreclosure is sanctified by the test in Bankruptcy Code § 547(b)(5).[193] Thus, the *Garner* case was rightly decided. There was no voidable preference in that case.

If *Garner* interprets U.C.C. § 9-332(b) too narrowly, more troubling are a number of cases that interpret it too broadly. For example, a bankruptcy trustee might invoke U.C.C. § 9-332(b) to claim that it is a transferee who takes free of a secured party's security interest in a deposit account. If this argument were accepted, security interests in deposit accounts would be worthless in bankruptcy (precisely where they should have the greatest utility). Fortunately, so far these arguments have landed on fallow ground. Properly, § 9-332(b) only applies to transfers of funds *out of* the account. It does not apply to transfers *of the account itself.*[194]

In *Limor v. First National Bank (In re Cumberland Molded Products, LLC)*,[195] a bankruptcy trustee tried to avoid the security interest of a bank in a

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190 *Id.* § 9-102(a)(64)(A).

191 *Id.* § 9-102(a)(9).

192 We assume here that B is a not transferee who, under § 9-322(b), takes free of B's own security interest, and that B therefore takes unencumbered funds which in turns makes B guilty of voidable preference. First, the syntax of § 9-332(b) makes clear that the transferee who takes free is not the secured party from whom the collateral is taken. Second, a transferee is someone who, before the transaction, had no interest in funds and who, after the transaction, obtains an interest for the first time. B, however, already owned the funds before the transaction and is not a first-time transferee.

193 To see why, we conduct the hypothetical liquidation test under § 547(b)(5). We may assume without loss of generality that the chapter 7 case is administratively insolvent and the unsecured creditors will receive a zero dividend. We are to imagine that the alleged $20,000 voidable preference is returned to the bankruptcy estate. 11 U.S.C. § 547(b)(5)(B). When the $20,000 is returned, it remains B's collateral, as the $20,000 is proceeds of the uncollected account. B takes this right back under § 725 as B's bankruptcy dividend in the hypothetical liquidation. Since B's bankruptcy dividend is $20,000, exactly the amount of the alleged preference, B has not been preferred.

This analysis assumes that the general operating account contains *only* cash proceeds and so is not a commingled account, which was likely to have been the case where SP1 and SP2 claimed all the assets of D.

194 U.C.C. § 9-332 cmt. 2. Two other cases rejected a similar argument. In each of these cases a secured party argued that a bank should not be able to enforce its perfected security interest and setoff rights against cash proceeds deposited in a commingled deposit account maintained by the bank because the bank colluded with the debtor within the meaning of U.C.C. § 9-332(b). The courts correctly held that U.C.C. § 9-332(b) only governed funds transferred out of a deposit account, not the relative priority of creditors with respect to funds in the account. *Ky. Highlands Inv. Corp. v. Bank of Corbin, Inc.,* 217 S.W. 3d. 851 (Ky. Ct. App. 2006); First Dakota Nat'l Bank v. First Nat'l Bank of Plainview, 2011 U.S. Dist. LEXIS 106102, *19–20 (D.S.D. Sept. 19, 2011).

195 *In re* Cumberland Molded Prods., LLC, 431 B.R. 718 (B.A.P. 6th Cir. 2010) (reversing Limor v. First

deposit account the contents of which were turned over to the trustee. Disastrously, the bankruptcy court accepted the trustee's arguments that the bank's security interest became unperfected because the (i) bank gave up control when it delivered the funds to trustee, (ii) the trustee was a transferee under U.C.C. § 9-332(b) who took free and clear of the security interest on the funds, and (iii) according to *Citizens Bank v. Strumpf*,[196] the bank should have temporarily frozen the account and was to be punished because it did not.

An appellate panel reversed on all three points. First, the time for determining whether a security interest is perfected is the commencement of the case. Back then, the bank still had control of the account for the obvious reason that it had not yet turned the funds over to the trustee.[197] The court also noted in passing that, whether or not a turnover of funds to the trustee is a waiver of the set-off right,[198] it does not terminate a security interest.[199]

Second, the trustee's withdrawal of the funds from the deposit account did not make him a transferee of the funds within the meaning of U.C.C. § 9-332 (b). Official Comment 2 states:

> The term "transferee" is not defined; however the debtor itself is not a transferee. Thus this section does not cover the case in which a debtor withdraws money (currency) from its deposit account . . .[200]

It is true that, upon the filing of the petition, all of the debtor's property was *transferred* to the trustee.[201] But this does not make the trustee a § 9-332(b) transferee. One must distinguish between a person paid by the depositary bank from the account and a person who takes over the *entire* account and is a new customer. In effect, the trustee (or *any* judicial lien creditor) succeeds to the entirety of the account and is the customer of the bank who is withdrawing his own funds.[202] That is, the trustee is the transferee of the deposit account itself, not of funds withdrawn from the account. The *Limor* court noted that the policy

Nat'l Bank of Woodbury, 2009 Bankr. LEXIS 2300 (Bankr. M. D. Tenn. July 21, 2009)).

196 Citizens Bank of Maryland v. Strumpf, 516 U.S. 16 (1995).

197 *In re* Cumberland Molded Prods., LLC, 431 B.R. at 723. Here the court suggests in passing that the bank might have lost its rights to exercise a set-off by turning over the funds. We dispute this "banker's dilemma" argument *infra* in text accompanying notes 370–88.

198 *In re* Cumberland Molded Prods., LLC, 431 B.R. at 725 ("compliance with a turnover request or the release to the trustee by a creditor holding a secured claim may result in a waiver of the ability to setoff . . ."). In fact, a bank does not waive a setoff right by paying funds to the trustee, since the Bankruptcy Code repeals the rule of "use it or lose it" for setoffs. *See infra* text accompanying notes 306–17.

199 *In re* Cumberland Molded Prods., LLC, 431 B.R. at 725.

200 U.C.C. § 9-332, cmt. 2.

201 *See infra* text accompanying notes 218–24.

202 *In re* Cumberland Molded Prods., LLC, 431 B.R. at 724.

of U.C.C. § 9-332(b) is to protect the free flow of funds in the checking system. It accords with common sense under Article 9 that a debtor cannot free collateral from a security interest by transferring funds to himself. Neither can the bankruptcy trustee or any other judicial lien creditor. If this were not true, then the security interest in a deposit account is worthless in bankruptcy, and banks are thrown back to their common law right of setoff.[203]

In *Orix Financial Services, Inc. v. Kovacs*,[204] a California Appellate Court misinterpreted U.C.C. § 9-332(b) to mean that lien creditors are "transferees" of funds within the meaning of that section. Such a holding completely vitiates the priority rules of Article 9. Even more significantly, if *Kovacs* is correctly decided, then perfected security interests in deposit accounts are worthless in bankruptcy.

In *Orix*, the secured party was not the bank at which a deposit account is maintained, but a lender who claimed cash proceeds deposited in the deposit account. A judgment creditor garnished the account. Apparently the funds were paid out to the garnishor. The secured party brought an action against the garnishor for unjust enrichment and sought imposition of a constructive trust.

Disastrously, the appellate court affirmed the trial court's holding that the lien creditor was a transferee who took free of a security interest in a deposit account.[205] Recognizing that the debtor itself cannot be a transferee of its own

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[203] Finally, the appellate panel rejected the idea that *Strumpf* implies a penalty on banks who proceeds by means other than freezing the account. The court held that *Strumpf* merely stands for the proposition that, under the facts of that case, the bank's freeze of the account did not violate the automatic stay. It does not suggest that a bank must freeze the account to protect its security interest. Indeed, we would again point out that *Strumpf* involved a bank's right of set-off and not a security interest under Article 9. *In re* Cumberland Molded Prods., LLC, 431 B.R. at 725.

In *In re* Mitkem Technologies, 2009 Bankr. LEXIS 2755 (Bankr. D. Mass. Aug. 31, 2009), the court ruled that U.C.C. § 9-332(b) does not disencumber deposit accounts, but for the wrong reason. The court held that the trustee was not a transferee because it had the rights of a lien creditor who takes subject to a perfected security interest. This would seem to be incorrect. Although the U.C.C. does not define the word "transfer", the term would seem to be broader than the definition of "purchase" in U.C.C. § 1-201(b)(29). "Purchase" excludes judgment liens because it is limited to voluntary transactions. Bankruptcy Code § 101(54) does define transfer to include, *inter alia*, "the creation of a lien." Consequently, the trustee is almost certainly a transferee.But, as *Limor* correctly notes, he is the transferee *of the deposit account itself*. When she takes funds out of the account, however, she is withdrawing her own funds, not transferring them to another.

[204] Orix Fin. Serv.'s, Inc. v. Kovacs, 83 Cal. Rptr. 3d 900 (Cal. App. 2008); *accord.* Stierwalt v. Associated Third Party Adm'rs, 2016 U.S. Dist. LEXIS 68744 (N.D. Cal. May 25, 2016).

[205] Orix Fin. Serv.'s, Inc., 83 Cal. Rptr. 3d at 901, 905. Although a lien creditor would seem to be a transferee "for value," since the judicial lien is "security for . . . a preexisting claim," U.C.C. § 1-204(2), the *Orix* court noted that, even if a garnishor is *not* "for value" (as the secured party argued), the point was irrelevant since the operative language of the section is "transferee," not purchaser for value or transferee for value.

funds it withdraws,[206] the court found that "transferee," as that term is used in § 9-322(b), is broad enough to include lien creditors.[207] The fact that the *comments* to the section use the word "payment" (a voluntary transfer) rather than "transfer" *simpliciter* did not, the court thought, overrule the broader statutory language in the code itself.[208]

This reading of U.C.C. § 9-332(b) efficiently destroys the priority regime of § 9-327 and § 9-317(a)(2). Rather, to avoid this catastrophe, the logic of *Limor* should be followed: a bankruptcy trustee (who is, after all, a lien creditor)[209] is in the position of a customer withdrawing its own funds and, therefore, not a § 9-332(b) transferee. Similarly, when a lien creditor garnishes a deposit account, it succeeds to the entirety of the debtor's interest in the account. The money paid out of the account to a lien creditor constitutes a withdrawal by the debtor's successor to the deposit account itself—not a transfer of funds from the account. Section 9-332(b) only disencumbers transfers "of funds from a deposit account." A judicial lien creditor is a transferee, but not of "funds" from the account. It is the transfer of the deposit account itself. If this is wrong, then security interests in deposit accounts are worthless in bankruptcy.

Imagine that a depositary bank takes a security interest in the deposit account it maintains for the debtor. Suppose the debtor grants a second security interest in the same deposit account to some lender C. This security interest is not only second in time but is unperfected to boot, where the depositary bank does not yield control ("control" being the *exclusive* means for perfecting a security interest in a deposit account as original collateral). C takes a security interest in the *whole* of the account and is not a "transferee of funds" within the meaning of § 9-322(b).[210] Otherwise, Article 9's cherished "first to perfect or file" rule[211] would be subverted with regard to deposit accounts. Yet C is *precisely analogous* to a judicial lien creditor, who should be treated as *not a transferee* within the meaning of § 9-322(b).

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206 *See* U.C.C. § 9-332 cmt. 2.

207 There was also no evidence that the lien creditor "colluded" with the debtor merely because it may have known of the security interest. Orix Fin. Servs., Inc., 83 Cal. Rptr. 3d at 901–02. Indeed, the fact that the debtor did not volunteer to pay the funds to the lien creditor strongly proves lack of collusion between the debtor and the garnishor. 167 Cal. App. 4th at 250–51.

208 The court also ruled irrelevant Comment 2(c) to old U.C.C. § 9-306, which refers to funds "paid out in the operation of the debtor's business." The *Orix* court viewed the Comment as overridden by the 2000 amendments. 167 Cal. App. 4th at 250.

209 11 U.S.C. § 544(a)(1); U.C.C. § 9-102(a)(52)(C).

210 *See* U.C.C. § 9-332 cmt. 2 ("Subsection (b) applies to *transfers of funds from* a deposit account itself or of an interest therein. For example, this section does not apply to the creation of a security interest in a deposit account").

211 *Id*. § 9-322(a)(1).

With regard to C in the above paragraph, the *Orix* court[212] stated that its holding is consistent with the equally questionable case of *GE Capital Corp. v. Union Planters Bank, N.A. (In re Machine., Inc.).*[213] In *GE Capital*, a senior secured party (the "floor plan lender") lost its priority in identifiable cash proceeds traceable into a commingled deposit account maintained by a junior secured party (the "bank").[214] The floor plan lender objected to the terms of a plan of reorganization that would give the bank priority in these proceeds. The bankruptcy court held that the floor plan lender lost its security interests because U.C.C. § 9-332(b) "recites that a transferee of cash proceeds takes the cash free of any security interest in the cash proceeds."[215] This is incorrect. The section has nothing to do with "cash proceeds" going *into* a deposit account, it only disencumbers funds coming *out* of a deposit account.

Nevertheless, for a completely different reason, the bank was senior. It claimed the deposit account as original collateral and it had (by definition) "control" of the deposit account. Under § 9-327(1) and (3), this control establishes priority over the floor plan lender, who perfected by mere filing. Notice that, under § 9-332(b) as it was misapplied in *GE Capital*, the floor plan lender lost its security interest entirely. Under the application of § 9-327, the floor plan lender would have retained a security interest, albeit one junior to the depositary bank's security interest.[216]

To summarize, unless we are to subvert the Article 9 priority system and render security interests in deposit account invalid in bankruptcy, lien creditors and junior secured parties are not "transferees of funds from the deposit account" within the meaning of U.C.C. § 9-332(b) but transferees of the deposit account itself. This interpretation coheres with the black-letter rule that a lien creditor's rights in property cannot exceed those of the debtor. If the debtor's rights are subject to a perfected security interest, then so are the rights of the lien creditor. A lien creditor's writ of garnishment may order the bank to pay over a fixed amount of the funds. Nevertheless, the lien creditor claims the whole of the

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212 Orix Fin. Serv.'s, Inc., 83 Cal. Rptr. 3d at 905.

213 GE Capital Corp. v. Union Planters Bank, N.A. (*In re* Mach., Inc.), 342 B.R. 790 (Bankr. E.D. Mo. 2006).

214 *Id*. at 793–94. The senior secured party had priority because it was the first to file a financing statement and the two secured parties had entered into an intercreditor agreement specifying that senior secured party would have priority in debtor's inventory that it financed and proceeds thereof. *Id*.

215 *Id*. at 798. The court also found that the depositary bank did not "collude," which would have negated the force of § 9-332(b). *Id*.

216 *See* U.C.C.§ 9-327. In addition, the floor plan lender had signed a subordination agreement in favor of the depositary bank. U.C.C. § 9-339 provides that "[t]his article does not preclude subordination by agreement by a person entitled to priority."

account, not to the potentially lesser amount of funds designated in the lien creditor's writ.[217]

II. STRUMPF

So far we have contrasted the noncontractual right of setoff with the contractually generated Article 9 security interest of a bank in the depositary accounts it maintains. Within the purview of the U.C.C., we have distinguished between the moments in which contract describes the deposit account in a two-person universe and moments when a deposit account is considered "property" in a three-person universe. We now consider *Citizens Bank v. Strumpf*,[218] in

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[217] Banner Bank v. First Community Bank, 854 F. Supp. 2d. 846 (D. Mont. 2012), presented the occasion for interpretation of § 9-332(b). In *Banner*, Bank 1 took a security interest in propane tanks. This security interest was perfected by filing. Subsequently, two principals of the debtor borrowed money from Bank 2 in their personal capacity. This loan purported to be secured by the same propane tanks (which the principals claimed to own but did not). Bank 2 did not claim the deposit account it maintained for the principals as original collateral.

Two propane tanks were sold. Approximately $80,000 from the sale of these tanks was deposited in a deposit account in a third bank, and a check in that amount written on Bank 3 was deposited in the principals' deposit account at Bank 2.

Properly, the *Banner* court held that Bank 2 was no transferee under § 9-332(b). At the time of the deposit with Bank 2, the principals had a positive balance in their deposit account (though the bank also had a common law setoff right). When the principals deposited the check on Bank 3, Bank 2 took possession of the instrument as agent of the debtors. Just as debtors cannot be transferees under § 9-332(b), neither can *agents* of debtors be such transferees. Therefore, Bank 2 could not claim to be a protected transferee. According to the court:

> the policy underlying this statute, which is in part to provide finality for further transactions by innocent transferees is not at issue here. [Bank 2] is not a transferee who has received funds from [the principals] and then used those funds to purchase some goods or services in another, further transaction that is entitled to finality. Indeed, the Court is uncertain whether [Bank 2] can be a transferee for purposes of this statute for the reason that [the principals] transfer into their [Bank 2] loan account is a credit to their account, and a transfer to themselves, and not an outright transfer to [Bank 2].

Banner Bank, 854 F. Supp. 2d. at 855–56. The court also found that Bank 2 "colluded" and was thus disqualified from § 9-322(b) protection.

Ironically, if Bank 2 had succeeded in showing that the debtors had conveyed encumbered tanks to the principals, and if Bank 2 had a security interest junior to that of Bank 1, Bank 2 would have prevailed. At first blush, Bank 2 was junior to Bank 1 under the terms of § 9-325(a)—the notoriously difficult "double debtor" provision. But § 9-325(a) is made subject to § 9-325(b), which provides: "Subsection (a) subordinates [Bank 2] only if the [Bank 1] security interest: (1) otherwise would have priority solely under Section 9-322(a) [first to perfect or file] or 9-324 [purchase money priority]." In fact, since Bank 2 maintained the deposit account for the principals, Bank 2 had priority under § 9-327(1) because it "controlled" the deposit account wherein the disputed cash proceeds were deposited. Since control is the trump card, Bank 2 wins as to the proceeds even though Bank 2 was junior as to the original collateral. Notice that this reasoning holds even though Bank 2 is *not* claiming an *original collateral* security interest in the deposit account it maintains for the principals. In short, any time a junior creditor is a bank, a deposit of cash collateral implies that the junior creditor gets a promotion.

[218] Citizens Bank v. Strumpf, 516 U.S. 16, 21 (1995).

which the Supreme Court *denied* that deposit accounts are "property" of the bankruptcy estate.

Before we can assess this holding, we need an excursus into the federal law of property as it applies to deposit accounts owned by bankrupt debtors. Nothing here is what it seems to be. Surprisingly, nearly forty years after the Bankruptcy Code was enacted, there are rather basic unsettled questions for which no answer is clearly satisfactory

A. Deposit Accounts as Property of the Bankruptcy Estate

1. Creation of the Estate in General

Bankruptcy constitutes a transfer of a debtor's prepetition property to a bankruptcy estate.[219] Thus, Bankruptcy Code § 541(a) provides:

> The commencement of a case under section 301, 302, or 303 . . . creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:
>
> (1) . . . all legal or equitable interests of the debtor in property as of the commencement of the case.[220]

Why is commencement of the case a "transfer"? It suffices to observe that, a few minutes before the bankruptcy petition, the debtor had full power to possess, consume, and alienate her property. After the bankruptcy petition, at least some of these powers have disappeared and have been created in the bankruptcy trustee. The simultaneous disappearance of power in the debtor and the appearance of the same power in the trustee means that bankruptcy consists of a transfer from the debtor to the bankruptcy trustee of at least some of the debtor's interests in property.[221]

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[219] David Gray Carlson, *Bankruptcy's Organizing Principle*, 26 FLA. ST. UNIV. L. REV. 249 (1998).

[220] 11 U.S.C. § 541.

[221] *In re* Spears, 308 B.R. 793, 800–01 (Bankr. W.D. Mich. 2004), *rev'd* 313 B.R. 212 (W.D. Mich. 2004). Judge Jeffrey Hughes has written:

> Ironically, the creation of a separate bankruptcy estate and the immediate transfer of the debtor's property into that newly created estate are so basic to bankruptcy law that they have become virtually transparent to the critical observer. While court after court will incant that a bankruptcy proceeding creates an estate and that all of the debtor's property becomes property of the estate, it is seldom that a court has actually paused to appreciate the profound effect these principles have upon property law.

Spears v. Boyd (*In re* Spears), 313 B.R. 212 (W.D. Mich. 2004).

What kind of transfer? This question is answered by Bankruptcy Code § 544(a). With regard to personal property (and, for that matter, real property), the bankruptcy estate creates a judicial lien in favor of the trustee.[222] Creation of a lien is always a transfer from the debtor to a creditor (in this case, to the bankruptcy trustee, a fiduciary representative of creditors).[223] It is a transfer of the whole deposit account, not just a transfer of a part of it. For this reason, U.C.C. § 9-332(b) does not disencumber the deposit account of a bank's perfected security interest.[224]

2. *Deposit Accounts and Property*

A deposit account is, of course, property in the three-person universe. Thus, bankruptcy constitutes a transfer of a deposit account from the debtor to a bankruptcy trustee.[225] One minute before bankruptcy, the debtor is the bank's customer. But at the instant a bankruptcy petition is filed, the trustee is the customer as the garnishee of deposit account. Before bankruptcy, the bank owes a contractual duty to pay to the order of the debtor. At the moment of bankruptcy,[226] the bank's duty is to pay to the order of the trustee as garnishor of the deposit account.[227]

A deposit account, not surprisingly, consists solely of discrete deposits. Commonly, these deposits will consist of checks written to the debtor's order on deposit accounts maintained by other banks. Once the deposited check is honored, the debtor has a final settlement withdrawable as of right.[228]

What is the status of checks that a debtor deposits before bankruptcy but which are presented and paid after bankruptcy? Prior to bankruptcy, a depositary

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222 11 U.S.C. § 544(a)(1)–(2) (2018).

223 *See id*. § 101(54) ("The term 'transfer' means—(A) the creation of a lien . . . ."). A special rule (not our concern here) makes the trustee a bona fide purchaser (who has recorded) of the debtor's prepetition realty. *Id*. § 544(a)(3).

224 *See supra* text accompanying notes 194–217.

225 *See* Boyer v. Carlton, Fields, Ward, Emmanuel, Smith & Cutler, P.A. (*In re* United States Diversified Prods., Inc.), 100 F.3d 53, 55–56 (7th Cir. 1996).

226 A debtor has the duty to file a "schedule of assets and liabilities." 11 U.S.C. § 521(B)(I). If a debtor acts prudently, she maintains a running account of her outstanding balance after she writes her check. She must not, however, report in her schedules the amount deducting outstanding checks. Rather, she must report the account as it exists as enhanced by any checks written but not yet cleared as of the time of the bankruptcy petition. *In re* Figueira, 163 B.R. 192, 195 (Bankr. D. Kan. 1993).

227 *See In re* Figueira, 163 B.R. 192, 194–95 (Bankr. D. Kan. 1993).

228 *See* U.C.C § 2-415(d) ("If a collecting bank receives a settlement for an item which is or becomes final, the bank is accountable to its customer for the amount of the item and any provisional credit given for the item in an account with its customer becomes final").

bank will credit the debtor with a "provisional settlement."[229] Under Article 4, a provisional credit is nothing at all—a bookkeeping entry[230] until the provisional credit becomes a final credit. May a debtor claim the *final* credit that results when the deposited check clears is postpetition property? If so, then the final credit resulting from the prepetition deposit belongs to the debtor personally, not to the bankruptcy trustee.[231]

The answer is that the postpetition final settlement is property of the estate because it is *proceeds* of prepetition property of the debtor that has become property of the estate.[232] Suppose, prior to bankruptcy, the debtor owns a payment intangible payable by some account debtor. Just prior to bankruptcy, the account debtor issues a check to the debtor's order. Issuance of the check suspends the underlying obligation to pay.[233] Thus, a suspended payment intangible (*i.e.*, contingent property) enters the bankruptcy estate. The final credit is proceeds of the suspended payment intangible.

Or suppose the debtor sells prepetition merchandise in exchange for a personal check. Delivery of the goods obligates the buyer to pay.[234] Once again, the buyer's obligation is suspended while the check is in the process of clearing. The debtor's conditional right of payment is property of the bankruptcy estate, and final postpetition settlement is proceeds of that conditional payment.

In *Barnhill v. Johnson*,[235] the Supreme Court fixed the moment of payment as the time at which the account debtor's check is honored (thereby entitling the account debtor's bank to debit the account debtor's checking account).[236] Although *Barnhill* involved a debtor who was the drawer of a check, its logic concerning the nature of a check and timing in bankruptcy equally applies to the opposite situation that we discuss here, in which the debtor is the payee of the check.

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[229] *See id.* § 4-201(a).

[230] *Id.* § 4-215(b) ("If provisional settlement for an item does not become final, the item is not finally paid").

[231] *See* 11 U.S.C. § 541(a)(1) (At least in a chapter 7 case, postpetition property of the debtor is not transferred to the trustee as of the filing of a bankruptcy petition).

[232] *See* 11 U.S.C. § 541(a)(6) (the bankruptcy estate "is comprised of . . . (6) proceeds . . . of . . . property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case . . . .").

[233] *See* U.C.C. § 3-310(b).

[234] *Id.* § 2-507(1) ("tender of delivery "entitles the seller . . . to payment according to the contract").

[235] Barnhill v. Johnson, 503 U.S. 393 (1992).

[236] *See id*. at 394–95 ("We granted certiorari to decide whether, in determining if a transfer occurred within the 90-day preference period, a transfer made by check should be deemed to occur on the date the check is presented to the recipient or on the date the drawee bank honors it. We hold that the latter date is determinative.").

Barnhill precludes the conclusion that the account debtor's *check* is property of the estate, and that the postpetition final settlement is proceeds of the *check*. In *Barnhill*, a debtor issued a prepetition check to pay antecedent debt to its creditor (*i.e.*, the debtor was an account debtor, using the U.C.C.'s terminology). As is well known, payments by insolvent debtors to unsecured creditors can be voidable preferences, if the other elements of Bankruptcy Code § 547 are present.[237] The debtor's check was issued before the ninety-day preference period. The check was honored in the preference period. For better or worse,[238] the Supreme Court ruled that the creditor had received a voidable preference, but in doing so it was careful to deny that final payment was proceeds of the *check*. Therefore, it is necessary to leave checks out of the proceeds theory. Instead, by the Supreme Court's logic, we must think of the postpetition final settlement as proceeds of the underlying (suspended) obligation of the debtor's account debtor to pay.[239]

3. *The Bank's Duty to Pay the Trustee*

When the debtor with a deposit account files for bankruptcy, the bankruptcy trustee becomes the bank's customer. The postpetition duty of the bank to pay these funds to the trustee is memorialized in Bankruptcy Code § 542(b), which provides that:

> an entity that owes a debt that is property of the bankruptcy estate and this is . . . payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor.

We note and reserve for later the significant point that the bank's duty to pay the trustee is suspended if the bank has a countervailing setoff protected under § 553.[240]

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[237] 11 U.S.C. § 547(b).

[238] *See* Barnhill, 503 U.S. at 400. In our opinion, worse.

[239] To use the terminology of an influential voidable preference case, the trustee obtains the "ledger balance" of the deposit account, not the "collected funds balance." Laws v. United Missouri Bank, 98 F.3d 1047 (8th Cir. 1996). The collected funds balance was there defined as collected deposits less debits. The ledger balance was defined as all collected and all *uncollected* deposits.

[240] 11 U.S.C. § 553(a) (2018) ("this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a m of such creditor against the debtor that arose before the commencement of the case . . . ."). This absolute statement is qualified by several exceptions. First, the automatic stay in Bankruptcy Code § 362 is an exception. Section 362(a)(7) prohibits "the setoff of any debt owning to the debtor that arose before the commencement of the case under this title against any claim against the debtor . . . ." Second, the trustee's power to use, sell or lease property of the estate under Bankruptcy Code § 363 overrides this statement. As we shall see, the trustee

Notice that § 542(b) refers to the deposit account as debt *and* as "property." This is because § 542(b) operates in a three-person universe in which debts (such as deposit accounts) are "property." That is, the debt is owed by the depositary bank to the debtor, but is now payable to a third—the bankruptcy trustee. Justice Scalia in *Strumpf* denied that deposit accounts were "property," but he was operating in the two-person universe—the world of the depositary bank and the bankruptcy trustee (to whom the debt is owed).[241] Hence, deposit accounts are not "property" for the purpose § 362(a)(3) (preventing third parties from controlling "property of the estate). But *debts* (including deposit accounts) are property in the purview of § 542(b).[242]

In pursuit of this point, note that Bankruptcy Code § 542(a) provides:

> an entity . . . in possession, custody, or control, during the case, of property that the trustee may use, sell, or lease under section 363 of this title . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.[243]

Thus, the Bankruptcy Code distinguishes between *debts* (covered by § 542(b)) and *property* (covered by § 542(a)). This distinction between § 542(b) and § 542(a) reflects the distinction between contract (*i.e.*, debts) and property. As we shall see deposit accounts are "debts" when the trustee pursues the depositary bank directly. Thus § 542(b) applies.[244] Deposit accounts are "property" when the trustee pursues the debtor for wrongfully embezzling estate funds by writing postpetition checks on the trustee's deposit account. Thus, § 542(a) applies.[245]

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has a conditional right to use the bank account in spite of the setoff right. *See infra* text accompanying notes 310–16. Finally § 553(a) and § 553(b) negate certain preferential and otherwise improper setoffs that a bank might otherwise make under state law. These last limitations are beyond the scope of this Article.

[241] To be precise, the debtor in *Strumpf* was a chapter 13 debtor with a confirmed plan. *See infra* text accompanying notes 345–56. Thus, by virtue of plan confirmation, the debtor succeeded to the trustee's right against the depositary bank. The exact sentence in the text is true in a chapter 7 or chapter 11 case (before confirmation) and in a chapter 13 case (before confirmation).

[242] Citizens Bank v. Strumpf, 516 U.S. 16, 20 (1995). We elaborate on Justice Scalia's interpretation *infra* in the text accompanying notes 328–33.

[243] 11 U.S.C. § 542(a).

[244] Turner Grain Merch., Inc. v. Helena Nat'l Bank (*In re* Turner Grain Merch., Inc.), 557 B.R. 147, 150 (Bankr. E.D. Ark. 2016).

[245] 11 U.S.C. § 542.

4. *Floating Checks*

A debtor may have written prepetition checks and may file for bankruptcy before those checks are actually presented. These checks have been called "floating."[246]

A scrupulous debtor will keep a ledger of checks written, so that she will know what the balance of the deposit account is. This prevents the debtor from writing NSF checks[247] by accident. When she files for bankruptcy and files a schedule of assets,[248] the debtor may be tempted to list as an asset the balance in her carefully kept ledger. This, however, is an error.[249] The debtor should list this ledger amount, *plus* the amount representing checks that have been issued but have not yet cleared.[250] Thus, the debtor must consult her balance at the local ATM at the exact time of the bankruptcy petition to determine the true amount of deposit account, against which floating checks have not yet been charged.[251] The debtor has the duty to surrender this *enhanced* amount to her bankruptcy trustee.[252]

Properly, our scrupulous debtor should stop payment on all prepetition checks[253] and should refrain from writing postpetition checks, as the deposit account now belongs to the bankruptcy trustee. Sadly, in the degraded demimonde in which we live, prepetition checks are not always stopped[254] and postpetition checks are improperly written by unscrupulous debtors.

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[246] David R. Hague, *Turnover Actions and the "Floating Check" Controversy*, 2013 UTAH L. REV. 63, 64–66 (2013).

[247] NSF stands for "not sufficient funds." Such checks are likely to "bounce."

[248] 11 U.S.C. § 521(a)(1)(B); FED. R. BANKR. P. 1007(b)(1). This schedule of assets is known as Official Form 106A/B.

[249] *In re* Figueira, 163 B.R. 192, 195 (Bankr. D. Kan. 1993) ("While doing so is understandable, it was an error to list the account with a zero balance" when floating checks existed").

[250] *In re* Parker, 2008 Bankr. LEXIS 1046, at *3 (Bankr. N.D.N.Y. April 3, 2008).

[251] *In re* Figueira, 163 B.R. at 194.

[252] 11 U.S.C. § 521(a)(4) ("if a trustee is serving in the case, [the debtor must] surrender to the trustee all property of the estate . . ."); *In re* Borowiec, 396 B.R. 598, 601 (Bankr. W.D.N.Y. 2008).

[253] 11 U.S.C. § 521(a)(4) (A debtor is obliged to "surrender to the trustee all property of the estate . . ."). This necessitates stop payment orders on all outstanding checks, although merely notifying the bank of the bankruptcy petition would have the same effect. Jubber v. Ruiz (*In re* Ruiz), 455 B.R. 745, 753 (B.A.P. 10th Cir. 2011). "A debtor, on the other hand, runs the risk of being prosecuted for writing a bad check if he attempts to stop payment on an outstanding check on the eve of bankruptcy. [But] the debtor would likely prevail if he faced criminal charges for such conduct, presuming he acted without fraudulent intent . . . ." Brown v. Pyatt (*In re* Pyatt), 486 F.3d 423, 427 (8th Cir. 2007), *aff'd*, Brown v. Pyatt (*In re* Pyatt), 486 F.3d 423 (8th Cir. 2007)); *see also In re* Parker, 2008 Bankr. LEXIS 1046, at *13 (Bankr. N.D.N.Y. April 3, 2008) ("The Debtor declares that the Trustee's suggestion that he should have advised his bank not to honor his outstanding pre-petition checks is unworkable as the fees charged by a bank would be exorbitant . . . .").

[254] Brown v. Pyatt (*In re* Pyatt), 486 F.3d 423, 427 (8th Cir. 2007).

These postpetition presentments should be dishonored by the bank. The bankruptcy trustee is now the customer, not the postpetition debtor. But often banks do not know of the bankruptcy when improper checks are presented. On occasion, the bank pays a check that properly should have been dishonored.

Prior to the enactment of the Bankruptcy Code, banks were in a difficult situation with regard to the floating check. The pre-Code story of the floating check is complex. At first, under the Bankruptcy Act of 1898, bankruptcy was not automatic. Bankruptcy had to be "adjudicated," even if the petition was voluntary.[255] Because the bankruptcy might conceivably be dismissed in the subsequent adjudication, the Bankruptcy Act of 1898 (starting in 1938)[256] authorized the debtor, prior to the actual adjudication, to make postpetition transfers of estate property to good faith transferees.[257] This power protected the banks from double liability when the debtor wrote checks in the ordinary course.

In 1959, however, Congress decided that adjudication of voluntary petitions was a waste of judicial time. It therefore amended the Bankruptcy Act to provide that a voluntary petition was automatically deemed to be have been adjudicated.[258] As a result, in voluntary cases, the debtor had no prepetition power to order the bank to pay a check. Such checks were wrongfully honored. The trustee could demand that the bank pay up as if the postpetition presentment had never occurred.[259]

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255 National Bankruptcy Act of 1898, § 18(g); Everett v. Judson, 228 U.S. 474 (1913). "[F]or many years prior to 1959 the entry of the adjudication order in voluntary proceedings was essentially a matter of routine, occurring promptly after the filing of the petition and receiving virtually no public attention." Hal M. Bateman, *Post-Bankruptcy Transfers: An Old Problem in Need of a New Solution*, 53 CORNELL L. REV. 280, 294 (1967).

256 Walter Chandler, The Revised Bankruptcy Act of 1938, 24 A.B.A. J. 880 (1938).

257 According to the 1898 Act § 70(d):

> After bankruptcy and either before adjudication or before a receiver takes possession of the property of the bankrupt whichever first occurs
>
> (1) A transfer of any of the property of the bankrupt, other than real estate, made to a person acting in good faith shall be valid against the trustee if made for a present fair equivalent value or, if not made for present fair equivalent value, then to the extent of the present consideration actually paid therefor, for which the transferee shall have a lien upon the property so transferred
>
> (2) A person indebted to the bankrupt or holding property of the bankrupt may, if acting in good faith, pay such indebtedness or deliver such property, or any part thereof, to the bankrupt and upon his order, with the same effect as if the bankruptcy were not pending;
>
> (3) A person having actual knowledge of such pending bankruptcy shall be deemed not to act in good faith unless he has reasonable cause to believe that the petition in bankruptcy is not well founded . . .

258 Act of June 23, 1959, Pub. L. No. 86-64, 1, 73 Stat. 109 (adding 1898 Act 18(f)).

259 Darrell W. Dunham, *Postpetition Transfers in Bankruptcy*, 39 U. MIAMI L. REV. 1, 4–5 (1984); *see* Bateman, *supra* note 255, at 285, 295 ("At no point in the drafting, consideration, and enactment of this amendment does it appear to have been recognized that in voluntary proceedings the amendment would have

In *Marin Bank v. England*,[260] a panel of the Ninth Circuit, wringing its six hands in anguish, felt that it had no choice but to subject a bank to liability, where the bank had honored a prepetition check of the debtor without knowledge of the bankruptcy petition. The Supreme Court, however, came to the rescue.[261] In a much criticized opinion,[262] the Court, in effect, legislated an immunity for the bank that unknowingly honored an improper check.

The *Marin Bank* majority theorized at some length the status of the bankruptcy trustee as garnishor of the depositary bank:

> [W]e do not agree with the Court of Appeals that the bankrupt's checking accounts are instantly frozen in the absence of knowledge or notice on the part of the drawee of the bankruptcy. The trustee succeeds only to such rights as the bankrupt possessed; and the trustee is subject to all claims and defenses which might have been asserted against the bankrupt but for the filing of the petition . . . The relationship of bank and depositor is that of debtor and creditor, founded upon contract. The bank has the right and duty under that contract to honor checks of its depositor properly drawn and presented . . . absent a revocation that gives the bank notice prior to the time the checks are accepted or paid by the bank.[263]

This strange passage echoes a theme that we will analyze in Justice Scalia's opinion in *Strumpf*—the bank account seems not to be property but rather only a contract. The passage from *Marin Bank*, however, ignores the fact that bankruptcy constitutes a *garnishment* of the deposit account. Once garnished, the bank precisely does *not* have the duty to honor the debtor's checks. Rather, the garnishment stands for the bank's obligation to pay the garnishing judicial officer only. We observe that this particular passage from *Marin Bank*, denying that deposit accounts are property, has largely been ignored in subsequent developments.[264] Bank accounts *are* considered garnishable property in the

the effect of eliminating all protection under section 70d for innocent third parties involved in post-bankruptcy transactions, although this result appears logically inevitable").

260 Bank of Marin v. England, 352 F.2d 186, 188 (9th Cir. 1965), *rev'd*, Bank of Marin v. England, 385 U.S. 99 (1966).

261 Bank of Marin v. England, 385 U.S. 99, 103 (1966). A famous moment in this opinion is Justice Douglas's confession, "Yet we do not read these statutory words with the ease of a computer." *Id*. at 190.

262 *See* Bateman, *supra* note 255, at 285, 300–05; Douglas G. Boshkoff, *Section 70(d) of the Bankruptcy Act: The Need for Amendment*, 43 IND. L.J. 755, 763 (1968) ("poorly articulated rejection of a state property concept"); Note, *Bankruptcy: Bank Which in Good Faith and without Notice Honors Client's Check after He Is Adjudicated Bankrupt Not Liable to Trustee for Depletion of the Bankrupt's Estate*, 1967 DUKE L.J. 1023, 1024 (1967).

263 Bank of Marin, 385 U.S. at 101.

264 *But see* United States v. Harchar, 371 B.R. 254, 261 (N.D. Ohio 2007) (implying the *Strumpf* was influenced by this passage).

trinary universe consisting of the debtor, the depositary bank and the bankruptcy trustee. This is a distinction that Justice Scalia saw; we do not read Justice Scalia as "following" the anti-property remark from the *Marin Bank* opinion.

Although its statutory justification was weak, the basic result in *Marin Bank* was found to be good policy and so it was eventually codified into the Bankruptcy Code as §542(c):

> Except as provided in section 362(a)(7) of this title, an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate, or pay a debt owing to the debtor, in good faith . . . to an entity other than the trustee, with the same effect as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been committed.[265]

Importantly, the immunity accorded under §542(c) is predicated upon no "actual notice" or "actual knowledge" of the commencement of the case.

Thus, the depositary account is property of the estate after the bankruptcy petition. But the Bankruptcy Code empowers the debtor to write postpetition checks on the bank, at least in the sense that the unknowing bank, having once paid to the order of the debtor, does not have to pay a second time to the trustee.

Section 542(c) basically preserves the power of an unknowing agent to convey property of the bankruptcy estate as if it still had authority from the debtor to convey the property.[266] But, while § 542(c) excuses the bank from liability for following the debtor's orders, it does not acquit transferees of liability.

For starters anything the debtor bought with the wrongfully honored check is property of the bankruptcy estate, which includes, not just the debtor's prepetition property but any "proceeds . . . from property of the estate."[267] Thus, if the debtor wrote a prepetition check to pay for a prepetition blender, and if the check is paid by an unknowing bank after bankruptcy, the blender is the debtor's prepetition property and therefore in the bankruptcy estate.[268] Or, if a postpetition blender is bought with a check issued after bankruptcy, the blender

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265 11 U.S.C. § 542(c).

266 But for § 542(c), bankruptcy usually terminates agency-principal relations. Rest. 2d Agency § 124 cmt. C ("Upon bankruptcy of the principal, the power of the agent to affect things which pass to the trustee in bankruptcy terminates without notice to him").

267 11 U.S.C. § 541(a)(6).

268 *Id.* § 541(a)(1).

is proceeds of the deposit account, which is also property of the bankruptcy estate.[269]

Alternatively, the trustee may avoid the transfer to the postpetition payee on the check.[270] According to Bankruptcy Code § 549(a):

> the trustee may avoid a transfer of property of the estate--
> (1) that occurs after the commencement of the case; and
> (2)(A) that is authorized only under section 303(f)[[271]] or 542(c) of this title; or
> (B) is not authorized under this title.[272]

It does not help the payee if payment was authorized by § 303(f)[273] or § 542(c) because these provisions only protect the bank, not the payee. But if some provision other than these authorizes the transaction, the trustee may not recover from the payee.[274]

A person who takes a prepetition check and postpetition payment has received a transfer voidable under § 549(a).[275] With regard to the seller of the

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269 *Id*. § 541(a)(6).

270 Thomas v. Money Mart Fin. Servs. (*In re* Thomas), 311 B.R. 75 (Bankr. W.D. Mo. 2004).

271 11 U.S.C. § 303(f). Section 303(f) applies in the period after an involuntary petition is filed and before the courts orders relief against the debtor pursuant to Bankruptcy Code § 303(h). In the interim "the debtor may continue to use, acquire, or dispose of property as if an involuntary case concerning the debtor had not been commenced." 11 U.S.C. § 303(f).

272 *Id*. § 549(a).

273 If § 303(f) applies, the trustee may not avoid transfers:

> to the extent any value, including services, but not including satisfaction or securing of a debt that arose before the commencement of the case, is given after the commencement of the case in exchange for such transfer notwithstanding any notice of knowledge of the case that the transferee has.

Id. § 549(b).

274 Yoon v. Minter-Higgins, 399 B.R. 34 (N.D. Ind. 2008) (rejecting the idea that Bankruptcy Code § 362(b)(11) authorizes payees to retain postpetition payments). Section 362(a) is the automatic stay generated by a bankruptcy petition. Various parts of § 362(a) prevent entities from receiving property of the estate. But § 362(b) affords many exceptions to the automatic stay. According to § 362(b)(11), the automatic stay does not prohibit "the presentment of a negotiable instrument and the giving of notice of and protecting dishonor of such an instrument . . . ." The district court in *Yoon* denied that permitting presentment was the same thing as authorizing payment. If this were wrong, then § 549(a) avoidance would have been rendered a dead letter in any case involving payment by check.

275 In our continuing hypothetical, the seller of the blender who presented the check received from the debtor is liable to the trustee under § 549(a) for the payment, but the seller does not violate § 362(a)(3) for refusing to turn over the payment in the absence of an adversary proceeding. When the depositary bank pays without knowledge of the bankruptcy under § 542(c), the payment is free and clear of the bankruptcy estate. The third party actually owns these funds. They may be *avoided*, however, under § 549(a). Davison v. Kanipe, 410 B.R. 607 (E.D. Tenn. 2009); Buckeye Check Cashing, Inc. v. Meadows (*In re* Meadows), 396 B.R. 485 (B.A.P. 6th Cir. 2008). Only when the trustee *recovers* the payment does the payment again become property of the

prepetition blender who took a personal check honored after bankruptcy, that seller is liable for the postpetition payment. Presumably, state law rescues the merchant. Under the cash sale doctrine which is now set forth in U.C.C. § 2-507(2), the buyer's right vis-a-vis the seller to retain the blender is conditioned on the seller's receiving payment.[276] If the trustee can recover the payment from the seller under § 549(a) then the seller may recover the blender out of the bankruptcy estate. In effect, when the debtor took the blender in exchange for a prepetition check, the debtor obtained only a *voidable* title under the cash-sale doctrine.[277] Thus, the trustee (being a lien creditor and *not* a bona purchaser for value) obtains only a voidable title.[278] The merchant of the blender continues to retain the right to avoid the trustee's title and take back the blender.

It has disturbed some that if the check to the order of the merchant had cleared before bankruptcy, the trustee cannot claim that the merchant has received a voidable preference. The merchant will have received funds on antecedent debt, but the merchant has a defense under § 547(c)(1), which was designed specifically to defend payment by check for contemporaneously exchanged value.[279] Yet, if the check clears *after* bankruptcy, the same merchant has received a sum that the trustee can recover for the benefit of the unsecured creditors. One scholar long ago suggested that the entire dilemma presented in *Marin Bank* could be avoided if the courts would make a federal rule that a check delivered prepetition but honored postpetition is really a prepetition payment.[280]

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estate, 11 U.S.C. § 541(a)(3); David Gray Carlson, *Bankruptcy's Acephalous Moment: Postpetition Transfers Under the Bankruptcy Code*, 21 EMORY BANKR. DEV. J. 113 (2004) (arguing that § 549(a) avoidance is needed only when the transferor has power to convey the estate free of the trustee's hypothetical judicial lien).

[276] According to § 2-507(2), "Where payment is due and demanded on the delivery to the buyer of goods or documents of title, his right as against the seller to retain or dispose of them is conditional upon his making the payment due."

[277] U.C.C. § 2-403(1) reads in relevant part:

> A person with voidable title has power to transfer a good title to a good faith purchaser for value. When goods have been delivered under a transaction of purchase the purchaser has such power even though
>
> . . .
>
> (b) The delivery was in exchange for a check which is later dishonored . . . .

U.C.C. § 2-403(1).

[278] *Id.* § 2-403(1) (If a trustee were deemed a bona fide purchaser of value, the trustee would succeed to a perfect title).

[279] "Normally, a check is a credit transaction. However, for the purposes of this paragraph, a transfer involving a check is considered to be 'intended to be contemporaneous,' and if the check if presented for payment in the normal course of affairs, which the Uniform Commercial Code specifies as 30 days, U.C.C. § 3-503(2)(a), that will amount to a transfer that is 'in fact substantially contemporaneous.'" S.R. No. 95-989 95th Cong., 1st Sess. 373 (1977); *see* Vern Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 760–61 (1985).

[280] According to Professor Boshkoff:

If a relation-back principle existed, the payee's liability could be adjudicated under voidable preference law, where the seller of the blender would certainly prevail. *Barnhill v. Johnson*[281] seems to preclude such a rule.[282] As it stands, when a check clears postpetition, the merchant is liable for the payment under § 549(a).[283] An overruling, or at least a limitation, of *Barnhill* would greatly improve the coherence of deposit accounts as property of the bankruptcy estate.

Even less clear is the trustee's right to recover the wrongful payment from the debtor.[284] The trustee's cause of action (if it exists) is described by Bankruptcy Code § 542(a), which provides:

> Except as provided in subsection (c) . . . an entity . . . in possession, custody, or control, *during the case*, of property that the trustee may use, sell, or lease, or that the debtor may exempt under section 522 of this title, shall deliver to the trustee, and account for, such property, *or the value of such property*, unless the property is of inconsequential value or benefit to the estate.[285]

The circuits have cleft themselves in twain over whether the debtor must reimburse the bankruptcy estate for prepetition checks honored after bankruptcy. In *Brown v. Pyatt (In re Pyatt)*,[286] the court assumed that if an entity *once* had control of estate property but has given it up before the trustee's turnover proceeding commenced, the trustee has no remedy against that entity.[287] This accords with an ancient Supreme Court holding in *Maggio v. Zeitz*,[288] which considered a judicially created turnover remedy in the absence of any statutory counterpart to Bankruptcy Code § 542(a).[289] According to the *Maggio* court:

> It is far from clear that *Bank of Marin* was anything other than a poorly articulated rejection of a state property concept; if, under state law, the transaction had been consummated when the check was drawn rather than when it was presented for payment there would have been no argument about the validity of the bank's action. State rules of substantive law need not, and indeed have not, been accepted by bankruptcy courts when the frustrate a clearly expressed bankruptcy policy.

Boshkoff, *supra* note 262, at 763.

281 Barnhill v. Johnson, 503 U.S. 393 (1992).

282 In *Barnhill*, a creditor received a check on antecedent debt 92 days before bankruptcy. The check was honored in the preference period. The Supreme Court ruled that payment occurred within the preference period. Courts feel that *Barnhill* constrains them in postpetition payment cases. *In re* Taylor, 332 B.R. 609, 610–11 (Bankr. W.D. Mo. 2005); *In re* Dybalski, 316 B.R. 312, 316 (Bankr. S.D. Ind. 2004); *In re* Maurer, 140 B.R. 744 (D. Minn. 1992).

283 *In re* Taylor, 332 B.R. at 613.

284 *See generally* Hague, *supra* note 246, at 95 (favoring debtor liability).

285 11 U.S.C. § 542(a) (emphasis added).

286 Brown v. Pyatt (*In re* Pyatt), 486 F.3d 423 (8th Cir. 2007).

287 *Accord In re* Taylor, 332 B.R. 609.

288 Maggio v. Zeitz, 333 U.S. 56 (1948).

289 *Id*. at 63–64 (interpreting a pre-Code nonstatutory duty to turn over).

> The nature and derivation of the remedy make clear that it is appropriate only when the evidence satisfactorily establishes the existence of the property of its proceeds and possession thereof by the defendant at the time of the proceeding. While some courts have taken the date of bankruptcy as the time to which the inquiry is directed, we do not consider resort to this particular proceeding appropriate if, at the time it is instituted, the property and its proceeds have already been dissipated, no matter when the dissipation occurred. Conduct which has put property beyond the limited reach of the turnover proceeding may be a crime . . . but no such acts, however reprehensible, warrant issuance of an order which creates a duty impossible of performance, so that punishment can follow.[290]

Recent courts, however, have declared *Maggio* to be overruled by enactment of § 542(a).[291] The words "during the case" imply that, where an entity was once

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290 *Id.*

291 Boyer v. Carlton, Fields, Ward, Emmanuel, Smith & Cutler, P.A. (*In re* United States Diversified Products, Inc.), 100 F.3d 53, 55 (7th Cir. 1996). The *Diversified Products* case involved the trustee's suit against a *nondebtor* that once had control of estate property, but the case would clearly apply to *debtors* who illegally dispose of estate property. *See also* Jubber v. Ruiz (*In re* Ruiz), 455 B.R. 745, 751–52 (B.A.P. 10th Cir. 2011); Yoon v. Minter-Higgins, 399 B.R. 34 (N.D. Ind. 2008); *In re* Fleming, 424 B.R. 795, 804 (Bankr. W.D. Mich 2010) (debtor can be an entity within the meaning of Bankruptcy Code § 542(a)); Toledano v. Kittay (*In re* Toledano), 299 B.R. 284, 298–99 (Bankr. S.D.N.Y. 2010); *In re* Borowiec, 396 B.R. 598, 601 (Bankr. W.D. N.Y. 2008) ("the court has never hesitated to order a debtor to pay to a trustee the value of assets that the debtor has wilfully dissipated subsequent to the filing of a bankruptcy petition"); *In re* Sawyer, 324 B.R. 115, 122 (Bankr. D. Ariz. 2005). In Beaman v. Vandeventer Black, LLP (*In re* Shearin), 224 F.3d 353 (4th Cir. 2000), the court agreed that *Maggio* was overruled by the Bankruptcy Code. In *Shearin*, the debtor filed for bankruptcy; thereafter the firm paid the debtor his year-end share of firm profits. The court held that the firm, as a former possessor of estate property, was liable for the value of the prepetition profits.

Considerable controversy erupted over whether the *Shearin* court had overruled Hager v. Gibson, 109 F.3d 201 (4th Cir. 1997). The majority read *Hager* as holding that a shareholder's prepetition control of a bank account could not predicate a turnover proceeding, simply because the shareholder never had control of property of the estate. This reading strikes us as entirely correct. In *Hager*, the shareholder had purchased a bank's secured loan against the debtor corporation. The shareholder in part used his own funds to buy the bank's right; in part he used the debtor's checking account. The court properly ruled that the funds in the debtor's checking account constituted the bank's cash proceeds, the surrender of which could not be viewed as wrongful. In effect, the debtor corporation was paying (or surrendering cash proceeds in satisfaction of) the bank's secured claim. The shareholder in effect bought the postpayment claim with his own funds.

There is some injustice in the *Hager* case. Once armed by assignment with the bank's rights, the shareholder liquidated inventory (which was the shareholder's collateral). The landlord, however, protested (dubiously) that the landlord was senior by virtue of a distress lien for rent. The shareholder agreed that the cash proceeds should be placed into escrow pending a court ruling on whether the landlord or the shareholder had the senior right to the cash proceeds.

The Fourth Circuit ruled, incomprehensibly, that the shareholder had subordinated itself to an unsecured creditor—the landlord. Accordingly, when the shareholder took the funds out of escrow (in apparent violation of the escrow agreement), the shareholder received a voidable preference under Bankruptcy Code § 547(b). This was clearly erroneous. The shareholder was simply taking cash proceeds. Taking cash proceeds is *never* a voidable preference. Taking these proceeds may have been a wrong to the landlord (which is extremely doubtful), but the shareholder's dispute with the landlord cannot be leveraged into a voidable preference historically in control of estate property, § 542(a) authorizes a tort action against that entity. The Ninth Circuit in *Shapiro v. Henson*[292] emphasized the phrase "during the case" in § 542(a):

> "[D]uring the case" means that the trustee may bring a motion for turnover against an entity who *has* possession of the property of the estate, or *had* possession of that property at some point during the bankruptcy. Section 542(a) does not include any words that hint at a narrower time of possession, and there is certainly no reference to the time of the motion's filing.[293]

Hence many courts think the debtor must pay a second time for the blender because, for a short while after the bankruptcy petition, the debtor historically had control over the deposit account, which was estate property.[294]

There is some unfairness in making the debtor pay twice. The debtor does not control when a payee presents a check.[295] Some of the postpetition checks could have been written months before the bankruptcy. Why should the debtor have to pay again when a payee has been dilatory in presenting the check? Had the check been promptly presented, it would have been a prepetition payment for which the debtor would not be liable.[296]

Be that as it may, the weight of authority says that the debtor must reimburse the trustee for postpetition payments from the deposit account.[297] But, returning

recovery for the trustee.

292 Shapiro v. Henson, 739 F.3d 1198 (9th Cir. 2014).

293 *Id*. at 1200.

294 Jubber v. Ruiz (*In re* Ruiz), 455 B.R. 745, 752–53 (B.A.P. 10th Cir. 2011); *In re* Sawyer, 324 B.R. 115 (Bankr. D. Ariz. 2005); *In re* Figueira, 163 B.R. 192, 195 (Bankr. D. Kan. 1993). Although the trustee must pursue the payee in an adversary proceeding, the debtor may pursue collection from the debtor by mere motion. FED. R. BANKR. P. 7001(1); *In re* Dybalski, 316 B.R. 312 (Bankr. S.D. Ind. 2004).

295 *In re* Minter-Higgins, 366 B.R. 880, 888 (Bankr. N.D. Ind. 2007), *rev'd sub nom.* Yoon v. Minter-Higgins, 2008 U.S. Dist. LEXIS 103496 (N.D. Ind., Feb. 8, 2008).

296 Yoon v. Minter-Higgins, 2008 U.S. Dist. LEXIS 103496 (N.D. Ind., Feb. 8, 2008).

297 In the last two decades, checks have receded as the primary means of withdrawing funds from deposit accounts. Large transfers of money between businesses are made through wire transfers governed by U.C.C. Article 4A. Consumer transfers, are also increasingly electronic with debit card transfers now exceeding checks in both volume and number of transaction. Both businesses and consumers also make transfers through automatic clearing house ("ACH") transactions. Because Article 4A transactions typically become final the same day, *Barnhill* issues will rarely arise in business bankruptcies. However, the issue of electronic payments has arisen in consumer bankruptcies.

In *In re* Gardner, 2015 Bankr. LEXIS 1097 (Bank. N.D. Ohio April 3, 2015), the court surveyed the law of the "floating check" in the context of debit cards. The court ruled that the controlling issue was whether the debtor had the right to obtain possession of the property at the commencement of the case. The court found that the debtor did have it in the case of checks and pre-given ACH orders because the debtor retained the right to stop payment. If, however, the debtor did not have the right to stop payment of posted debits, then she would have mere title in the her "account balance" and would only control the "available balance." Unlike U.C.C.

to our blender example, recovery should indicate that the debtor gets to keep the blender—not the trustee. Otherwise the trustee obtains a double recovery. The doctrinal basis for this is subrogation. When the debtor ordered its bank to pay the merchant postpetition for the prepetition blender, the debtor bought from the merchant all the merchant's rights. This includes the right to avoid the trustee's title to the blender should the payment fail. The debtor, in effect, steps into the shoes of the merchant, who can avoid the transfer of title to the blender if the payment fails.[298]

5. *Exempt Deposit Accounts*

To increase the vexation, in consumer cases, the deposit account is very likely to hold exempt funds. In New York, for example, ninety percent of income derived from personal services is exempt.[299] The exemption is suspended if the income is "unnecessary for the reasonable requirements of the judgment debtor

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Article 4 with respect to checks and the Electronic Funds Transfer Act ("EFTA") with respect to ACH orders, no statute gave debit card holder the right to stop payment. Consequently, the court ordered further hearings as to whether the contract between the debtor and her bank gave her a right to stop payment. If it did, she controlled the full amount of her account balance and would have to turn over the balance of the funds. If she didn't she would only have to turn over the available balance.

Although the court's reasoning sounds persuasive given *Barnhill*, it misstates the law of stop-payment orders, presuming that a customer may stop payment until a check is honored. Under U.C.C. § 4-403(a) a stop payment order must be received by a bank "at a time . . . that affords the bank a reasonable opportunity to act on it before any action by the bank" pursuant to U.C.C. § 4-303. This section, in turn, permits a bank to set a cutoff hour for this purposes "no earlier than one hour after the opening of the next banking day after the banking day on which the bank received the check and no later than the close of the next banking day or, if no cutoff hour is fixed, the close of the next banking day after the banking day on which the bank received the check." Moreover, under the EFTA (15 U.S.C. §§ 1693–1693r), a *consumer* has the right to stop a pre-given ACH debit order if she gives notice three business days before the scheduled payment date. The customer's rights are, however, also subject to rules issued by the National Automated Clearing House Association, as well as the contract between the customer and the bank. Consequently, in order to apply the court's principle, the question would not be whether the check or ACH payment had cleared postpetition, but whether the period for stopping payment had lapsed.

With respect to debit cards, the correct answer would seem to be that customer cannot stop payment. There are two basic types of debit cards. Charges made on PIN-based (on-line cards) are cleared when the card is "swiped." PIN-less (off-line) charges are cleared through the same networks as credit cards. Consequently, although the transaction is posted when the card is swiped, the merchant will not receive final payment for some time later. This apparently was the type of card that was involved in *Gardner*.

[298] In any case, it is likely the blender is property the debtor may exempt from the bankruptcy estate. If Bankruptcy Code § 522(d)(3) applies, the debtor may exempt "[t]he debtor's interest, not to exceed $600 in value in any particular item . . . in . . . appliances . . . that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor." State law may deprive debtor domiciliaries of the right to choose the § 522(d) exemptions, however. 11 U.S.C. § 522(b)(2). In that case, the blender must be exemptible under state law. Where § 522(d) does not apply because a state has "opted out," state law would have to exempt the blender. 11 U.S.C. § 522(b)(1).

[299] N.Y.C.P.L.R. § 5205(d)(1).

and his dependents."[300] In addition, New York law only exempts earnings for "personal services rendered within sixty days before . . . an income execution is delivered to the sheriff . . . ."[301] The exemption applies to wages already in a bank account when the bank account is levied.[302]

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300 *Id*. § 5205(d).

301 Where *no* income execution is delivered to the sheriff, § 5204(d) seems to say that no earnings are exempt, and the judgment creditor is entitled to 100% of earnings, if we read § 5202(d)(2) literally. In *Cadle Co. v. Newhouse*, 26 Fed. Appx. 69 (2d Cir. 2001), a debtor had all his wages deposited in his wife's checking account. An execution creditor claimed these deposits were fraudulent conveyances and (presumably) filed a turnover proceeding against the depositary bank in order to recover the proceeds of the checking account. The creditor tried to argue that, since it did not proceed by income execution, it was not subject to the 10% limit, but the court found that § 5205(d)(2) nevertheless limits the creditor to 10% of the wages. The court remanded to discover how much of the wages were spent on necessaries. This implies that the spouse of the debtor would have personal liability for expenditures "unnecessary for the reasonable requirements of the judgment debtor and [her] dependents." CPLR § 5205(d). The transfer of the "necessary" portion of the wages was a transfer of exempt property and therefore not susceptible of recovery as a fraudulent conveyance. United States v. Craft, 535 U.S. 274, 276 (2002).

302 *In re* Wrobel, 268 B.R. 342 (Bankr. W.D.N.Y. 2001). In In re Maidman, 141 B.R. 571 (Bankr. N.D.N.Y. 1992), the debtor claimed over $50,000 in cash (presumably in a bank account) because it represented ninety percent of the amount of wages earned within sixty days. This implies that the debtor's take-home pay for the year was about $333,333. The court allowed the debtor to exempt this amount under § 5205(d)(2). Overlooked, however, is the fact that the exemption does not cover amounts that "a court determines to be unnecessary for the reasonable requirements of the judgment debtor and his dependents." CPLR § 5205(d) (preamble). The *Maidman* court should have required the debtor to prove that the $50,000 was necessary to the debtor's reasonable requirements, a daunting task where the debtor's prodigious wallet was enlarded by $300,000 a year in post-bankruptcy earnings. *In re* Colbaugh, 250 B.R. 162, 166 n.9 (Bankr. W.D.N.Y. 2000) ("Although Rule 4003(c) places the burden of proof on an objecting party to demonstrate that an exemption has not been properly claimed, Courts have uniformly held that once the objecting party presents a prima facie case that the exemption has been improperly claimed, the burden then shifts back to the debtor to come forward with evidence to demonstrate that the exemption is proper"). In *Colbaugh*, the bankruptcy court issued the following instruction for debtors wishing to claim bank accounts exempt to the extent of the wages they contain:

> [T]his Court will: (1) require a debtor claiming an Earnings Exemption to: (a) provide proof of all earnings from personal services rendered within sixty days of the filing of the petition; and (b) if the Earnings Exemption is claimed in amounts on deposit in a financial institution, provide proof: (i) that the earnings were deposited into the account; and (ii) of the balance on deposit in the account on day sixty-one before the filing of the petition; (2) presume that any amount on deposit in the account at day sixty-one before the filing of the petition are the last amounts out of the account; (3) presume that ten percent of the debtor's earnings for services rendered within sixty days of the filing of the petition are the second to the last amounts out of the account; and (4) presume that any amounts deposited into the account within the sixty days before the filing of the petition from sources other than earnings for personal services rendered within sixty days of the filing of the petition are the third to last amounts out of the account. As a result, the Trustee and a debtor's estate will generally be entitled to the lesser of: (1) the amounts on deposit in the account on day sixty-one, ten percent of the debtor's earnings for services rendered within sixty days of the date of the filing of the petition and all non-earnings deposited into the account within sixty days of the filing of the petition; or (2) the amount on deposit in the account as of the date of filing.

Id. 166–67 (footnote omitted). Missing from this procedure is any acknowledgment that unnecessary funds belong to the trustee.

One would think that the debtor could write postpetition checks on the exempt part of a deposit account. But this is not the case. Largely because the Bankruptcy Code introduces an option to choose the federal exemptions under § 522(d), all exempt property initially enters the bankruptcy estate under § 541(a)(1). The debtor must fetch out exempt property by filing a Schedule C pursuant to Bankruptcy Code § 522(*l*). The trustee or the creditors are then given thirty days after the first creditors' meeting[303] to object to the exemption. In the case of New York wages, there are ample plausible grounds to object that the funds do not represent wages earned within sixty days of bankruptcy and that the funds are "unnecessary for the reasonable requirements of the judgment debtor . . ."[304] The Bankruptcy Code manages to block access to funds that may well *eventually* be exempted, because creditors may have valid objections to the exemption.[305] We will return to the conundrum of exempt funds later on.[306]

6. *Bank Setoff Rights*

A bank may have the ability under state law to set off a deposit account against some other obligation the debtor owes the bank. Under state law, setoffs are subject to the rule of "use it or lose it."[307] The Bankruptcy Code, however, transforms the setoff right (a contractual idea) into a property idea by proclaiming it a lien. According to Bankruptcy Code § 506(a):

> An allowed claim of a creditor . . . that is subject to setoff under section 553 . . . is a secured claim to the extent of . . . the amount subject to setoff . . . and is an unsecured claim to the extent that . . . the amount so subject to setoff is less than the amount of such allowed claim.[308]

Under this provision, the bank is a secured creditor for the amount of the deposit account balance on the day of the bankruptcy petition.

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303 The United States Trustee must call a creditors' meeting between twenty-one and forty days after the bankruptcy petition. FED. R. BANKR. P. 2003(a). Therefore, seventy days could well pass before an exemption becomes effective.

304 CPLR § 5202(d).

305 *See* Nucchino v. Wells Fargo Bank, N.A. (*In re* Nucchino), 439 B.R. 761 (Bankr. D.N.M. 2010) (bank account is property of the estate even though it might contain exempt funds); *accord*. Wells Fargo Bank, N.A. v. Jimenez, 406 B.R. 935 (D.N.M. 2008).

306 *See infra* text accompanying notes 404–13.

307 For a pre-Code case holding "use-it-or-lose-it" applied in bankruptcy cases, *see* Lowden v. Iowa-Des Moines Nat'l Bank & Trust Co., 10 F. Supp. 430 (S.D. Iowa 1935), *aff'd*, 84 F.2d 856 (8th Cir. 1936), *cert. denied*, 299 U.S. 584 (1936).

308 11 U.S.C. § 506(a).

The bankruptcy petition gives rise to the automatic stay which enjoins creditors from various acts detrimental to the bankruptcy trustee or the debtor. One of the automatic stay provisions prohibits the manifestation of a setoff.[309]

Does this mean that a bankruptcy trustee can deprive a bank of its collateral by withdrawing funds needed to sustain the setoff right? It does not. According to Bankruptcy Code § 542(b):

> an entity that owes a debt that is property of the bankruptcy estate and that is . . . payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor*.[310]

Thus, § 542(b) permits the setoff to serve as a defense to the obligation to pay, just as state law does.

Furthermore, a trustee may only use, sell or lease property of the estate out of the ordinary course of business with court permission.[311] The court is obliged, however, to grant "adequate protection" to a secured creditor such as a bank with a setoff right.[312] "Adequate protection" is a guarantee that the secured position of the creditor will not be compromised.[313] Although a trustee may be authorized to conduct an ongoing business of the prepetition debtor,[314] a trustee must still have court permission to use cash collateral,[315] which again triggers the creditor's right to adequate protection. Thus, a trustee might offer illiquid collateral in exchange for cash collateral.[316] But without adequate protection and court permission, using cash collateral is strictly out of bounds.

We may pause to ask, why does the Bankruptcy Code make manifestation of a setoff a violation of the automatic stay? The answer is that the Bankruptcy Code invites a trustee to obtain a coerced "loan" of cash collateral in exchange for some sort of illiquid collateral. Adequate protection implies that such coerced loans must be collateralized.

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309 *Id*. § 362(a)(7) (prohibiting "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor . . . ."). Certain exceptions for setoffs are made in § 362(b).

310 *Id*. § 542(b) (emphasis added).

311 *Id*. § 363(b).

312 *Id*. § 363(e).

313 *Id*. § 361.

314 *Id*. §§ 721, 1108, 1203, 1204, 1304.

315 *Id*. § 363(c)(2).

316 *Id*. § 361(2).

B. *Strumpf in Context*

In *Strumpf* the debtor filed a chapter 13 bankruptcy petition early in 1991.[317] At the time, the debtor was a customer of Citizens Bank of Maryland. Nine months later, the debtor's balance in the deposit account exceeded $11,000.[318] Meanwhile, the bank, in turn, had a much smaller countervailing claim for $3,250.48 on a promissory note requiring installment payments over a two-year period.[319]

Nine months after the bankruptcy proceeding, on October 7, 1991, the bank moved to lift the automatic stay so that it could manifest its setoff. At the same time, "Citizens Bank placed an administrative hold on $3,500 in Strumpf's checking account, pending a ruling by the Bankruptcy Court on the motion."[320] Presumably the bank notified the debtor that this hold existed. To be noted is that the bank merely made an *announcement* of its intent. It did not actually dishonor any check or any request for withdrawal by the debtor or trustee.

Two days later, on October 9, 1991, Mr. Strumpf moved that the bank be held in contempt for merely *announcing* the freeze. This motion was granted on November 21. The bankruptcy court took the freeze to be the same as a postpetition setoff prohibited by §362(a)(7) of the Bankruptcy Code.

On December 2, however, the bankruptcy court granted the bank's motion to lift the stay. Alas, "[b]efore the granting of Citizens Bank's Motion for Relief from Automatic Stay and Setoff, Strumpf had removed all funds from the checking account."[321]

Having been found guilty of violating the automatic stay, the bank appealed to the district court, which ruled that there was no setoff because a mere freeze is not the same as a setoff: "In fact, permitting the Bank to freeze the funds until such time as the Court rules on the Bank's Motion for Relief from Automatic Stay and setoff is the only sensible procedural approach under these circumstances."[322]

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317 Citizens Bank of Md. v. Strumpf, 1992 U.S. Dist. LEXIS 4617, at *2 (D. Md. March 27, 1992).

318 *Id*.

319 *Id*. at *2 n.1 (This was, at least, the bank's claim in October 1991).

320 *Id*. at *2.

321 *Id*. at *4.

322 *Id*. at *9.

From this ruling the debtor appealed, and the Fourth Circuit Court of Appeals reversed again.[323] The Court of Appeals characterized the situation as follows:

> If the debtor learns of the motion for relief from the stay, however, the debtor may defeat the creditor's right of setoff by removing all funds in the creditor's possession [sic] before the creditor can obtain relief from the stay. Therefore, even if the creditor is granted relief from the automatic stay, the creditor will have nothing with which to set off the debt owing it. As the district court recognized, this scenario is known as the "banker's dilemma."[324]

Although it characterized the depositary bank as in a dilemma, it nevertheless held (based on solid Fourth Circuit precedent)[325] that freezes are setoffs, so that the bank had violated the automatic stay.

The *Strumpf* case was further appealed to the Supreme Court, which reversed again. Justice Scalia emphasized that:

> Petitioner refused to pay its debt, not permanently and absolutely, but only while it sought relief under § 362(d) from the automatic stay . . . . All that concerns us here is whether the refusal was a setoff. We think it was not, because—as evidenced by petitioner's "Motion for Relief from Automatic Stay and for Setoff"—petitioner did not purport *permanently* to reduce respondent's account balance by the amount of the defaulted loan.[326]

Justice Scalia's idea was that a setoff implies "an intent permanently to settle accounts."[327] At the end of a setoff, there is only one claim left standing. Either the creditor has a deficit claim against the debtor (where the "collateral" was insufficient) or the debtor had a claim against the bank (where the bank is oversecured). Freezes are metaphysically different. With regard to a freeze, pending some future manifestation to set off, two mutual debts continue to exist. A setoff opportunity persists, but no actual manifestation of the setoff occurs. Two angels, not just one, dance on the head of this pin.

323 Citizens Bank v. Strumpf (*In re* Strumpf), 37 F.3d 155 (4th Cir. 1994).

324 *In re* Strumpf, 37 F.3d at 158. Needless to say, the creditor does not possess "funds" of the debtor. The court speaks metaphorically here.

325 *See* United States v. Reynolds, 764 F.2d 1004 (4th Cir. 1985) (In *Reynolds*, the Internal Revenue Service "froze" a tax refund in a chapter 13 case. The court found the freeze to be a stay violation).

326 Citizens Bank v. Strumpf, 516 U.S. 16, 19 (1995) (emphasis added).

327 *Id*. at 19.

Justice Scalia states his conclusion as a matter of federal law.[328] This assertion of a federal basis was probably designed to prevent decisions which found freezes to be setoff as a matter of *state* law.[329] Perhaps in aid of federalizing the reason, Justice Scalia refers to § 542(b), which provides:

> an entity that owes a debt that is property of the bankruptcy estate and that is . . . payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under section 553 of this title against a claim against the debtor*.[330]

This provision was paired with § 553(a) which "sets forth a general rule, with certain exceptions, that any right of setoff that a creditor possessed prior to the debtor's filing for bankruptcy is not affected by the Bankruptcy Code."[331] These two provisions, when combined, led to the conclusion that, for the purposes of § 362(a)(7), freezes are not setoffs:

> It would be an odd construction of § 362(a)(7) that required a creditor with a right of setoff to do immediately that which § 542(b) specifically excuses it from doing as a general matter: pay a claim to which a defense of setoff applies.[332]

Thus, the *Strumpf* opinion is written in the "plain meaning" mode for which Justice Scalia is famous. Some have suspected, however, that the result (freezes are not setoffs) is really just a pragmatic legislative carve-out as a matter of federal common law to solve the banker's dilemma.[333]

Justice Scalia's solution to the banker's dilemma faced a further hurdle. The debtor claimed that the bank had committed an act "to obtain possession of

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[328] Justice Scalia was schizophrenic on choice of law. On the one hand, the concept of setoff comes from state law. Strumpf, 516 U.S. at 18 ("Although no federal right of setoff is created by the Bankruptcy Code, 11 U.S.C. § 553(a) provides that, with certain exceptions, whatever right of setoff otherwise exists is preserved in bankruptcy."). On the other hand, his conclusion held *regardless* of the content of state law. *Id*. at 19 ("But even if state law were different, the question whether a setoff under § 362(a)(7) has occurred is a matter of federal law, and other provisions of the Bankruptcy Code would lead us to embrace the same requirement of an intent permanently to settle accounts").

[329] United States *ex rel* IRS v. Norton, 717 F.2d 767, 772 (3d Cir. 1983) (quoting Goldstein v. Jefferson Title & Trust Co., 95 Pa. Super. 167, 170 (1928)).

[330] Strumpf, 516 U.S. at 20 (emphasis added).

[331] *Id*. at 18.

[332] *Id*. at 20. *See In re* Carpenter. 14 B.R. 405, 407 ("The use of the phrase 'may be offset' [in Section 542(b)] clearly contemplates that the setoff right has not been exercised . . . . Thus, Congress has recognized a significant distinction between the withholding of payment and the exercise of the setoff right").

[333] Robert M. Lawless, *Legisprudence Through a Bankruptcy Lens: A Study in the Supreme Court's Bankruptcy Cases,* 47 SYRACUSE L. REV. 1, 85 (1996) (claiming that the case is pragmatism dressed up as formalism).

property of the estate or of property from the estate or to exercise control over property of the estate."[334] The debtor additionally claimed that when it announced its freeze, the bank had violated the prohibition against acts to collect or recover a prepetition claim from the debtor.[335]

These claims threatened Justice Scalia's pragmatic solution to the banker's dilemma. If the bank was exercising control of the bank account and if the bank account was "property of the estate," then the bank had violated the automatic stay all the same, even if a temporary freeze is no setoff.

As we have emphasized,[336] Justice Scalia held that the bank did *not* control "property" of the estate. In the two-person universe of debtor and bank, the deposit account was merely a contractual relationship. By refusing to honor the debtor's demand for a withdrawal, the bank was not controlling property of the debtor. It was merely refusing to perform its contractual obligation. This is the two-against-three distinction between contract and property that motivates our article:

> Finally, we are unpersuaded by respondent's additional contentions that the administrative hold violated §§ 362(a)(3) and 362(a)(6). Under these sections, a bankruptcy filing automatically stays "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate," 11 U.S.C. § 362(a)(3), and "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title," § 362(a)(6). Respondent's reliance on these provisions rests on the false premise that petitioner's administrative hold took something from respondent, or exercised dominion over property that belonged to respondent. That view of things might be arguable if a bank account consisted of money belonging to the depositor and held by the bank. In fact, however, it consists of nothing more or less than a promise to pay, from the bank to the depositor, and petitioner's temporary refusal to pay was neither a taking of possession of respondent's property nor an exercising of control over it, but merely a refusal to perform its promise.[337]

Thus, in Justice Scalia's view, the deposit account is not property of the bankruptcy estate when the bank breaches its contract by repudiating its duty to honor checks or withdrawals.[338] The deposit account *is* property when a third

334 11 U.S.C. § 362(a)(3).

335 *Id.* § 362(a)(6).

336 *See infra* text accompanying notes 2–3.

337 Citizens Bank v. Strumpf, 516 U.S. 16, 21 (1995).

338 *Cf.* James H. Wynn, Comment, *Freeze and Recoupment: Methods for Circumventing the Automatic*

party intervenes. For example, a postpetition garnishment of a bank account clearly violates the automatic stay because *three* persons are in this universe: the bank, the trustee, and the sheriff.[339]

Much stress is placed on the use of the word "temporary" by Justice Scalia. For the most part, "temporary" belongs to the setoff side of the opinion. Surely refusal to pay does not become the illegal control of property just because it is more than "temporary."[340] But there is one point in which Justice Scalia invokes temporariness as to whether refusal to pay is property or a breach of contract. Thus, "petitioner's *temporary* refusal to pay was neither a taking of possession of respondent's property nor an exercising of control over it, but merely a refusal to perform its promise."[341]

So far, we have delivered up a straightforward account of the reasoning of the lower courts and of the Supreme Court in *Strumpf*. In fact, nothing in this case is what it seems and hidden issues went unrecognized at all levels of appeal in this case.

1. *There Was at Best a Minimal Setoff in This Case*

In *Strumpf*, we are assured that the debtor's deposit account contained $11,000 against which the bank had a setoff opportunity of $3,250.48. Without more, it would appear that the bank was an oversecured creditor, entitled to postpetition interest under Bankruptcy Code § 506(b). But it is also true that the bank's motion to lift the automatic stay occurred nine months after the commencement of the chapter 13 case. Although the record is silent, it is very likely that the $11,000 balance in the checking account consisted of postpetition earnings.[342] The balance on the day of the bankruptcy petition may have been zero or may have been a lot less than $3,250.48.

Stay?, 5 BANKR. DEV. J. 85, 92 (1987) ("it is extremely difficult to deny that a freeze of a debtor's account does not constitute '[an] act . . . to exercise control over property of the estate.' As a result, Section 362(a)(3) is currently the debtor's strongest support for the proposition that a freeze constitutes a violation of the automatic stay.").

[339] *In re* Porayko, 705 F.3d 703, 705 (7th Cir. 2013) (bank account was "property" for the purpose of a prepetition garnishment); *In re* Watson, 78 B.R. 267, 268 (Bankr. C.D. Cal. 1987).

[340] *In re* Weidenbenner, 521 B.R. 74, 81 (Bankr. S.D.N.Y. 2014). We discuss this interesting opinion later. *See infra* text accompanying notes 392–99.

[341] Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 21 (1995) (emphasis added).

[342] 11 U.S.C. § 1325. In chapter 13, a debtor must pay all "disposable income" to the chapter 13 trustee. *Id.* § 1325(b). If the debtor were actually paying all disposable income to the trustee, then the funds in the deposit account by definition constitute nondisposable postpetition income.

If this is so, then the balance was wholly or partly unavailable for setoff by the bank. The bank is permitted to set off *prepetition* claims against the debtor (the installment loan) against the bank's countervailing *prepetition* obligation to the debtor.[343] To the extent of postpetition earnings, the setoff had become "triangular." The bank's claim for the installment loan was against the chapter 13 trustee, and the debtor's claim against the bank for postpetition earnings was not mutual. The most a bank could have claimed by way of setoff is the deposit account balance as it existed at the time of the bankruptcy petition.[344]

2. *If There Ever Was a Setoff Right, It was Destroyed by the Plan Confirmation*

Perhaps the bank in *Strumpf* had no or a very limited setoff right against the debtor, as the deposit account probably consisted of postpetition earnings. If this setoff right existed, it was surely destroyed when the bankruptcy court in *Strumpf* confirmed a chapter 13 plan on April 8, 1991, more than six months before the bank froze the deposit account.[345]

The plan in *Strumpf* is brief enough to quote in full:

> CHAPTER 13 PLAN
>
> I. PROPERTY AND FUTURE EARNINGS
>
> The debtors submit the following property to the supervision and control of the Trustee: wages in the amount of $100.00 per month for 48 months.
>
> II. CLASSIFICATION AND TREATMENT OF CLAIMS
>
> *Class 1*: Priority claim to pay attorneys fees in the amount of $500.00.
> *Class 2*: Trustee's compensation as allowed.
> *Class 3*: Allowed claims of unsecured creditors in the amount of $3,837.00 to be paid *pro-rata*.
>
> III. OTHER PROVISIONS

[343] *Id.* § 553. According to Bankruptcy Code § 553(a), "this title does not affect any right of a creditor to offset a mutual debt owing by such a creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case . . . ."

[344] *In re* Orr, 234 B.R. 249, 254–55 (Bankr. N.D.N.Y. 1999).

[345] United States v. Cont'l Airlines (*In re* Cont'l Airlines), 134 F.3d 536, 542 (3d Cir. 1998) (confirmation of plan erases prepetition setoff rights where the plan did not preserve them).

> 1. Payments by the Debtor will be made directly to the Trustee by the debtor beginning on or before February 28, 1991.
> 2. Regularly monthly payments to Chrysler Corp. will be made outside the plan.
> 3. Debtor intends to surrender furniture to HRSI.[346]

If the bank had a setoff claim, then this plan was strictly unlawful under chapter 13 and should never have been confirmed. That is, to the extent the bank had a setoff right protected by § 553(a), the bank was a secured creditor with a claim to cash collateral. Bankruptcy Code § 1325(a)(5)(B)(ii) requires that the secured creditor receive at least the value of the collateral. The plan certainly did not indicate that the deposit account is subject to the bank's security interest. Nor did the confirmation order do so. According to the confirmation order:

> [E]ach holder of an allowed secured claim provided for by the plan has accepted the plan; or that plan provides that the holders of such claims retain the liens securing such claims . . . .[347]

This language implies that the bank (a secured creditor) had acquiesced to destruction of its secured position.

Nevertheless, however unlawful, the plan is binding on creditors. According to Bankruptcy Code § 1327(a):

> The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.[348]

Furthermore, we learn from Bankruptcy Code § 1327(c) that:

> Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

Since the plan did *not* provide that the bank retain its setoff right, the deposit account vested in the debtor "free and clear of any claim or interest"[349] of the bank.

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[346] Record on Appeal Appendix A (Strumpf's Chapter 13 plan, filed Jan. 25, 1991).

[347] Record on Appeal Appendix C (Bankruptcy court Order confirming Strumpf's Chapter 13 plan, entered Apr. 8, 1991).

[348] 11 U.S.C. § 1327 (2018).

[349] *Id.* § 1327(c).

The Federal Rules of Bankruptcy Procedure make clear that lien avoidance requires an adversary proceeding.[350] At the time *Strumpf* was decided, courts struggled over the interpretation of plans which illegally wiped out otherwise valid liens.[351] Courts were divided; many struggled to find that a plan could not constitutionally provide, in the absence of an adversary proceeding, that the lien did not exist, or that a plan that was simply silent had to be interpreted as preserving the lien.[352] Such possibilities were effectively terminated by the Supreme Court in *United Student Aid Funds, Inc. v. Espinosa,*[353] a chapter 13 case in which an unlawful plan discharged a student loan in violation of Bankruptcy Rule 7001(6).[354] The plan was nevertheless binding on a student lender with minimal constitutional notice of the plan confirmation hearing. This more recent precedent takes a very hard line indeed on the *res judicata* effect of illegal chapter 13 plan. If the principle of *Espinosa* were applied (anachronistically) in *Strumpf*, it is clear that the bank's setoff right, if it ever existed, did not survive plan confirmation.[355]

On this very question, Justice Scalia in *Strumpf* wrote:

> We decline to address respondent's contention, not raised below, that the confirmation of his Chapter 13 Plan under 11 U.S.C. § 1327 precluded petitioner's exercise of its setoff right.[356]

Had Justice Scalia peered more deeply into the matter and had he anticipated the Supreme Court's future ruling in *Espinosa*, he would have discovered that the

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350 FED. R. BANKR. P. 7001 (2018). According to Federal Rule Bankruptcy Procedure 7001, "[t]he following are adversary proceedings . . . (2) a proceeding to determine the validity, priority, or extent of a lien or other interest in property."

351 Citizens Bank of Md. v. Strumpf, 1992 U.S. Dist. LEXIS 4617, at *6 (D. Md. March 27, 1992). According to the District Court:

> In the case at bar, no provision was made in Strumpf's Chapter 13 plan to pay Citizens Bank claim as a secured creditor. As such, the reorganization plan did not provide "adequate protection" for the Bank's security interest.

Citizens Bank of Md. v. Strumpf, 1992 U.S. Dist. LEXIS 4617, at *6 (D. Md. March 27, 1992); *see also In re* Strumpf, 37 F.3d at 158 ("[T]he fact that Citizens was not provided for as a secured creditor in Strumpf's plan might be taken into account in deciding whether the bankruptcy court should grant Citizens relief from the automatic stay under § 362(d)(1) . . . .").

352 David Gray Carlson, *The* Res Judicata *Worth of Illegal Bankruptcy Reorganization Plans*, 82 TEMPLE L. REV. 351, 366–71 (2009).

353 United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260 (2010).

354 11 U.S.C. § 523(a)(8). Student loans are not dischargeable in bankruptcy unless repaying them constitutes an undue hardship. Rule 7001(6) requires that matters of discharge be adjudicated in an adversary proceeding.

355 David Gray Carlson, *The Federal Rules of Bankruptcy Procedure in Reorganization Cases: Do They Have a Constitutional Dimension?*, 84 AM. BANKR. L. REV. 251, 265 (2010).

356 Citizens Bank v. Strumpf, 516 U.S. at 21 n.1.

bank had already lost the setoff right. Its only right was to receive a pro rata payment under the plan. The installment loan, on this line of thought, had disappeared and had been replaced by a right to installments under the plan. These installments are the obligation of the standing chapter 13 trustee, who receives the debtor's postpetition wages to fund plan payments. As such, what used to be a setoff right has now become triangular. That is to say, there were no longer mutual debts owing to the debtor and to the bank. Rather, the bank owed the debtor the amount of the checking account and the chapter 13 trustee owed the bank.

3. *The Automatic Stay in the Case Was Limited*

Not only was there no setoff right in *Strumpf*, but the automatic stay may have lapsed. If so, Bankruptcy Code § 362(a)(3) (control of estate property) would have had no application to the case.

Surprisingly, at this late stage in American history, the theory of the chapter 13 bankruptcy estate and the meaning of plan confirmation are still mysteries.[357] The most sensible view, based on § 1327(b),[358] is that when a chapter 13 plan is confirmed, the bankruptcy estate is largely conveyed back to the debtor.[359] If *that* is the theory of the bankruptcy estate, then § 362(a)(3) did not apply in the *Strumpf* case.[360] According to § 362(c)(1), "the stay of an act against property of the estate under subsection (a) . . . continues until such property is no longer property of the estate."[361]

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357 David Gray Carlson, *The Chapter 13 Estate and Its Discontents*, 17 AM. BANKR. INST. L. REV. 233, 233 (2009).

358 11 U.S.C. § 1327 (According to § 1327(b), "Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.").

359 *Id*. § 1327(b). Cash actually paid to the standing chapter 13 trustee could fairly be called "estate property" after plan confirmation. Carlson, *supra* note 357, at 237. In no sense was the bank in *Strumpf* attempting to interfere with this cash.

360 *Cf.* Mwangi v. Wells Fargo Bank, N.A. (*In re* Mwangi), 764 F.3d 1168 (9th Cir. 2014) (once a deposit account was exempted the account was not property of the bankruptcy estate and so 11 U.S.C. § 362(a)(3) no longer applied).

361 11 U.S.C. § 362(c)(1); *Id*. § 1327(b) (Section 1327(b) applies "[e]xcept as otherwise provided in the plan or the order confirming the plan . . ."), Sometimes debtors write a clause in the plan indicating that property of the bankruptcy estate *not* vest in the debtor—for the precise purpose of extending the automatic stay to the end of the plan. SouthTrust Bank v. Thomas (*In re* Thomas), 883 F.2d 991, 993 (11th Cir. 1989); *In re* Coker, 216 B.R. 843 (Bankr. N.D. Ala. 1997); *In re* Lambright, 125 B.R. 733, 735 (Bankr. N.D. Tex. 1991). Some courts find such plan terms to be contrary to public policy, though § 1327(b) directly invites it. *In re* Segura, 2009 Bankr. LEXIS 460 (Jan. 9, 2009); *In re* Jemison, 2007 Bankr. LEXIS 3107 (Bankr. N.D. Ala. September 6, 2007). No such clause existed in the *Strumpf* plan, however. *See supra* text accompanying notes 345–46.

There is another rather eccentric theory of the chapter 13 estate, which, if adopted, would entail application of § 362(a)(3). Section 1327(b) transfers property of the estate to the debtor, but § 1306(a)[362] brings in all property the debtor acquired after confirmation.[363] Thus, property of the estate on the day of confirmation is transferred back to the debtor, but *new* after-acquired property is property of the estate (not of the debtor). Section 362(a)(3) would then apply to this after-acquired property. Properly, though, the jurisdiction of § 1306(a) ends when the plan is confirmed.[364]

As the deposit account in *Strumpf* was likely to be composed of postconfirmation earnings, the automatic stay still would apply (under this theory) at least to the extent that the deposit account consisted of postpetition deposits. But this is precisely the part of the deposit account that is not available for setoff. Even under this eccentric theory of the bankruptcy estate, § 362(a)(3) could have no application.

Other parts of the automatic stay provision are candidates for relevance to the facts in *Strumpf*. Section 362(a)(5) prohibits any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case . . . ." If confirmation vests property of the estate in the debtor, the bank account becomes property of the debtor. This provision would not apply because (per *Strumpf*) the bank account is not "property." Thus, one might note that Justice Scalia erred in addressing § 362(a)(3), but his same reasoning applies just as well to § 362(a)(5).

Switching to § 362(a)(5) requires consideration of whether a setoff right constitutes a "lien." The enforcement of "liens" is what § 362(a)(5) prohibits. A lien is defined as "charge against or interest in property to secure payment of a

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362 11 U.S.C. § 1306(a). According to § 1306(a):

> Property of the estate includes, in addition to the property specified in § 541 of this title:
>
> . . .
>
> (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted . . .

Id.

363 United States v. Harchar, 371 B.R. 254, 265 (N.D. Ohio 2007); Holden v. United States (*In re* Holden), 236 B.R. 156 (Bankr. D. Vt. 1999). According to Bankruptcy Code § 1306(a), "property of the estate includes, in addition to the property specified in section 541 of this title . . . (2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title . . . ." Confirmation of the chapter 13 case is not the same as case closure. A chapter 13 case is closed only when the confirmed plan is complete. *In re* Ball, 2008 Bankr. LEXIS 1532, at *5 (Bankr. N.D.W. Va. May 23, 2008) ("Of course, Chapter 13 cases are not closed until after all plan payments have been made and a discharge entered").

364 Carlson, *supra* note 357, at 236.

debt or performance of an obligation."[365] If the deposit account is "property," a setoff right is plausibly a lien. For example, the setoff right survives a conveyance of the account itself and can be asserted against a transferee, so long as the countervailing claim arose prior to the assignment.[366] It is certainly plausible to think that the setoff right is a "charge" against the deposit account itself. On the other hand, it is equally plausible to think that the setoff right inhabits the two-person universe of contract. What is a setoff right, after all, but a defense against a customer's cause of action against the depositary bank for a debt? In this vein, the bank is declared a secured creditor by Bankruptcy Code § 506(a), but this is not entirely the same thing as asserting that setoffs are liens. Recall that Professor Gilmore declared the absurdity that setoffs are liens to be fan dancing.[367]

In any case, we have seen that, in *Strumpf*, the plan did not preserve the setoff right and so it was destroyed.[368] For this reason, there would have been no profit in worrying about whether § 362(a)(5) prohibits manifesting the setoff.

Finally, § 362(a)(6) may apply. This provision prohibits "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case . . . ." There is no reference to "property of the estate" in § 362(a)(6), and so a post-confirmation chapter 13 debtor might claim that, once confirmation destroyed the setoff right, a bank's refusal to honor checks constitutes an attempt to collect the prepetition claim against the debtor.

This aspect of the automatic stay figured in *Strumpf*, but Justice Scalia said little about it—only that he would not permit the section to interfere with his solution to the so-called banker's dilemma:

> we will not give . . . § 362(a)(6) an interpretation that would proscribe what § 542(b)'s "exception" and § 553(a)'s general rule were plainly intended to permit: the temporary refusal of a creditor to pay a debt that is subject to setoff against a debt owed by the bankrupt.[369]

But where the bank institutes a freeze after loss of the setoff right, the bank may find it has violated § 362(a)(6) because the freeze is motivated by a desire to collect a prepetition claim.[370]

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[365] 11 U.S.C. § 101(37).
[366] U.C.C. § 9-104(a)(2).
[367] *See supra* text accompanying notes 10–13.
[368] Citizens Bank v. Strumpf, 516 U.S. 16 (1995).
[369] *Id.* at 21.
[370] *Id.*

In short, there was no setoff in *Strumpf*, and it is far from clear whether there was an automatic stay—two not insignificant facts that eluded the attention of the Supreme Court.

4. *The Banker's Dilemma Never Did Exist*

The Court of Appeals expressly and the Supreme Court implicitly assumed that the bank faced a dilemma in bankruptcy. According to this supposed dilemma, either the bank had to obtain relief from the automatic stay in order to manifest the setoff or, under cover of the automatic stay, the debtor, in a chapter 13 case, could empty out the deposit account, thereby depriving the bank of its setoff opportunity. In other words, the courts assumed that the bank lived in the prepetition world of "use it or lose it."

But this assumption is patently wrong. The Bankruptcy Code in fact repeals the rule of "use it or lose it" and makes the bank a secured creditor. Its collateral is the deposit account, and the deposit account is the bank's cash collateral. According to Bankruptcy Code § 363(a), cash collateral is defined, *inter alia*, as "deposit accounts, or other cash equivalents . . . in which the estate and an entity other than the estate have an interest . . ." This cash collateral may not be used by a trustee without court permission, which will require a showing that the value of the collateral is "adequately protected" against dissipation through use.[371]

The governance of cash collateral in bankruptcy cases is rather confusingly described in the Bankruptcy Code. In a chapter 13 case, matters are even more confused.[372] Chapter 13 changes a great many rules that might apply in a chapter 7 case. With regard to deposit accounts, we learn in Bankruptcy Code § 542(b) that "an entity that owes a debt that is property" of the bankruptcy estate and that is ". . . payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee . . ." It would appear at first blush that the bank should pay the deposit account balance to the chapter 13 trustee, not to the debtor.

But this is countered by § 1322(b), which provides that "the debtor shall remain in possession of all property of the estate." Presumably "in possession" of a deposit account includes the right to make withdrawals from it or write

371 *See supra* text accompanying notes 311–16.

372 Cary v. General Motors Acceptance Corp. (*In re* Cary), 202 B.R. 796, 798–99 (Bankr. M.D. Ga. 1996) Setoff opportunities (including IRS tax refunds) together with insurance proceeds on encumbered assets are likely to be the only examples of "cash collateral" capable of figuring in a consumer bankruptcy under chapter 13.

checks upon it. We further learn in § 1306(a) that the debtor has, exclusive of the chapter 13 trustee, the "rights and powers of a trustee under sections 363(b), 363(d), 363(e), 363(f), and 363(*l*)."

The trustee's right to use cash collateral figures in Bankruptcy Code § 363(c)(2) and so this is a right *not* allocated to the debtor. To be sure, *some* chapter 13 debtors are "engaged in business."[373] To be engaged in business is to be "self-employed."[374] Self-employed debtors are "subject to any limitations on a trustee under sections 363(c)." Thus, *self-employed* debtors may not use cash collateral in the ordinary course of business, but there is no rule at all for debtors who are not self-employed.[375] Technically, the usual chapter 13 wage earner's right to use estate property is limited to use *dehors* the ordinary course of business, and any such use requires court permission. Read literally, a chapter 13 debtor must have a court's advance permission to use *any* part of the bankruptcy estate. Bankruptcy judges quietly ignore this conundrum[376] and acquiesce to usage out of the ordinary course of business without court approval.[377] But this acquiescence surely would not persist in the face of using a bank's cash collateral.[378]

To the extent the bank in *Strumpf* had any valid setoff opportunity for mutual *prepetition* debts (which is in question),[379] it is clear that the chapter 13 debtor had *no* lawful access to the checking account, even the amount in surplus of the setoff opportunity. After all, the *total* account is collateral for the amount of the

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373 11 U.S.C. § 1304(a).

374 *Id*. § 1304(a).

375 *In re* Rio, 55 B.R. 814, 817 (Bankr. M.D. Ala. 1985) (interpreting this gap to mean that the chapter 13 debtor was free to raid the bank's cash collateral).

376 Carlson, *supra* note 357, at 256–63 The conundrum ceases when plan confirmation vests property of the estate in the debtor (on the most sensible interpretation of the bankruptcy estate). *Id.* .

377 Bogdanov v. Laflamme (*In re* Laflamme), 397 B.R. 194, 204 (Bankr. D.N.H. 2008) ("The Bankruptcy Code . . . does not contain any explicit provision that governs what a debtor can do with chapter 13 estate property while the debtor is waiting to have a proposed plan confirmed. Presumably a debtor must be able to use earnings to pay ordinary and necessary living expenses in that interim gap period."); *In re* Fisher, 198 B.R. 721, 733 n.18 (Bankr. N.D. Ill. 1996), *rev'd on other grounds*, 203 B.R. 958 (N.D. Ill. 1997) ("Chapter 13 debtors have authority under Section 1303 to deal with estate property in the ordinary course, which should include expending estate property for ordinary living expenses. Only extraordinary purchases, sales, and credit transactions should require court approval.").

378 Cary v. General Motors Acceptance Corp. (*In re* Cary), 202 B.R. 796 (Bankr. M.D. Ga. 1996) (insurance proceeds from car wrecks). In nonbusiness cases, cash collateral may be used with court permission under Bankruptcy Code § 363(b). *But see In re* Orr, 234 B.R. 249 (Bankr. N.D.N.Y. 1999) (stating that a chapter 13 debtor has access to the bank's cash collateral without bank consent where the bank's freeze lasted too long; § 363(c)(2) applies only if the debtor operates a business): *In re* Rio, 55 B.R. 814, 817 (Bankr. M.D. Ala. 1985), *rev'd*, 82 B.R. 138 (M.A. Ala. 1986), *rev'd*, 82 B.R. 138 (M.D. Ala. 1986).

379 *See supra* text accompanying notes 342–44.

secured claim.[380] The surplus is as much "cash proceeds" as the amount generated by reference to the setoff opportunity.[381] In a chapter 11 case, imagine that secured party has a perfected security interest in all of the debtor's inventory and that, as of the filing of the petition, the debtor-in-possession had inventory worth $1 million and a "lockbox account" containing only proceeds of inventory worth $200,000. Suppose further that the secured creditor has an oversecured claim of $700,000. The debtor-in-possession cannot claim that the lockbox account is not cash proceeds. Rather, the debtor-in-possession is forbidden to use the lockbox account without court permission. Undoubtedly, a court will permit the use of the case on the grounds that the secured claim is already oversecured by the remaining inventory (so that the claim is "adequately protected" within the meaning of Bankruptcy Code 363(e)).[382] But still, court permission must be obtained, and the debtor-in-possession has no unilateral right to spend the proceeds over the opposition of the secured creditor. Surely this is also the rule in chapter 13.

It should be apparent from the description of the cash collateral regime that *the banker's dilemma does not exist.* Any demand by a bankruptcy trustee or debtor-in-possession that the deposit account be paid in spite of the setoff opportunity is an illegal assault on cash collateral. Presumably, no court will find impropriety in a bank refusing to pay an amount that is not due and owing to a chapter 13 debtor.

This fundamental point was emphasized early in a wise opinion that was unfortunately neglected by the Supreme Court in *Strumpf*. In *In re Edgins*,[383] a chapter 13 debtor owed the bank $12,500 and the bank owed the debtor the $7,100 balance of the deposit account. When the bank learned of the bankruptcy petition, the bank froze the deposit account. The debtor responded by alleging a violation of the automatic stay and sought a turnover of funds. The court concluded that the debtor was not entitled to expropriate the bank's cash collateral. Rather, the Bankruptcy Code had created a stalemate between banks and debtors. To break the stalemate, one side or the other would have to step forward to seek judicial relief. If the debtor moved first, it would seek permission

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380 *See* Skilton, *supra* note 73, at 140–41 ("the secured party's claim is on the entire account; the whole of the commingled fund becomes subject to his security interest, as well as such parts of the fund as the debtor has used for investment in other assets") (footnote omitted).

381 Bruce A. Markell, *Stumbling at the Sixth: A Troubling Test for Transfers in* Meoli v. The Huntington National Bank, 37 BANKR. L. LETTER 10 (May 2017).

382 Evan D. Flaschen, *Adequate Protection for Oversecured Creditors*, 61 AM. BANKR. L.J. 341 (1987) (The mere presence of an equity cushion for a secured creditor is usually thought to be adequate protection).

383 *In re* Edgins, 36 B.R. 480 (B.A.P. 9th Cir. 1984).

to use cash collateral and a turnover order. If the bank elected to move first, it could move to lift the stay for the purpose of manifesting the setoff. The Bankruptcy Code made no allocation between these parties as to the burden of proceeding first.[384]

The vision in *Edgins* is that the bank can sit back and do nothing; this passivity would not constitute a violation of the automatic stay because the debtor has no right to invade cash collateral.[385] Yet *Strumpf* implies that the bank must take the initiative by moving to lift the stay and that the bank is entitled to a *temporary* freeze only (pending the motion). Temporary freezes are not setoffs.[386] The temptation is to infer that, if the freeze lasts too long, it transmogrifies into a setoff and a violation of the automatic stay. Accordingly, since *Strumpf*, parties have litigated whether a freeze is not temporary because too much time had passed between the announcement of the freeze and the motion to lift the stay.[387]

It is distinctly odd that the caterpillar of freeze metamorphosizes into the illicit butterfly of setoff in cases (such as *Strumpf*) where there was no setoff

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[384] *In re* Edgins, 36 B.R. at 483. According to the *Edgins* court:

> When a creditor defers payment pursuant to an asserted right of setoff, the creditor is not entitled to actual setoff of the deferred funds, which would be a violation of 11 U.S.C. § 362. In turn, the debtor is not permitted to use cash collateral without first obtaining court authority and after notice and hearing. This stalemate may be alleviated by either party initiating a number of alternate proceedings in the bankruptcy court. Either party might make application for a declaratory determination of whether the frozen account is security by virtue of section 506(a) and thus subject to a right of setoff under section 553. A creditor might bring an action for relief from the automatic stay for the purpose of asserting and exercising its security interest and right to setoff. The debtor might bring a motion for use of the security as cash collateral under 11 U.S.C. § 363. Any of these methods could be pursued by motion . . . The Bankruptcy Code does not specify which should be used no whether the creditor or the debtor should initiate action to break what appears to be a statutory logjam.

In re Edgins, 36 B.R. at 483.

[385] *Id*. at 482. In *Edgins*, a plan had been confirmed. Therefore, it is likely that there was no automatic stay, and (if the plan was like the one in *Strumpf*) there was no setoff right. *See id*. at 483. The bankruptcy court "points out that the bank failed to object to confirmation of the debtor's Chapter 13 plan . . . ." The deposit account was simply not property of the bankruptcy estate at all.

[386] Citizens Bank v. Strumpf, 516 U.S. 16, 17 (1995) ("We must decide whether the creditor of a debtor in bankruptcy may, in order to protect its setoff rights, temporarily withhold payment . . . .") The bank's "temporary refusal to pay was neither a taking of possession of respondent's property nor an exercising of control over it, but mere a refusal to perform its promise." *Id*. at 20. Section 542(b) "plainly intended to permit: the temporary refusal of a creditor to pay a debt that is subject to setoff against a debt owed by the bankrupt." *Id*.

[387] Turner v. First Cmty. Credit Union (*In re* Turner), 462 B.R. 214 (Bankr. S.D. Tex. 2011) (indeterminate freeze; no motion to lift the stay); *In re* Cullen, 329 B.R. 52 (Bankr. N.D. Iowa 2005) (40 days); *In re* Schafer, 315 B.R. 765, 768 (Bankr. D. Colo. 2004) (six weeks); *In re* Orr, 234 B.R. 249, 255 (Bankr. N.D.N.Y. 1999) (2 months); Town of Hempstead Employees Fed. Credit Union v. Wicks, 215 B.R. 316, 319 (Bankr. E.D.N.Y. 1997) (four months).

right in the first place. One such case is *In re Cullen*,[388] where a chapter 7 debtor held a joint deposit account with his father. None of the funds in the account belonged to the debtor son. The bank put a freeze on the account, which supposedly generated damages to the debtor because the freeze had changed into a setoff because of a forty-day delay in the motion to lift the stay. How can a freeze be a setoff when there is no underlying countervailing claim in the first place?

The *Eglin* court got it right long ago—the bank's refusal to pay out cash collateral in the absence of a court order is not wrongful. By assuming that the banker's dilemma existed—that payout of cash collateral was required in the absence of relief from the automatic stay—Justice Scalia was misled into thinking that temporaneity was required to prevent a freeze from turning into a setoff. Properly, temporaneity should have been entirely left out of the equation.

5. Strumpf *Does Not Apply in Chapter 7*

We have seen that, in *Strumpf*, as a factual matter there was neither a bank setoff right nor an automatic stay due to plan confirmation. It would not be accurate, however, to conclude that the *Strumpf* rule (freezes do not violate the automatic stay) has *no* application in chapter 13 cases. It applies in the very brief period before a chapter 13 plan is confirmed. Properly, a debtor seeking the use of a bank's cash collateral must first obtain court permission pursuant to Bankruptcy Code § 363(b). But if a debtor does not seek this permission, and if the bank freezes the account *temporarily* in anticipation of an imminent motion to lift the stay, then the freeze is legally permitted. If the motion to lift the stay is not immediately forthcoming, then the freeze is a setoff. The bank will be punished even though it is illegal for the chapter 13 debtor to raid the cash collateral. Once plan confirmation occurs, however, the automatic stay disappears and *Strumpf* ceases to have any proper application.

If *Strumpf* has extremely limited application in chapter 13, it probably has *no* application whatever in chapter 7 or chapter 11 cases. If a trustee or debtor-in-possession wishes to raid the cash collateral of a bank, it must first obtain permission under § 363(b) or § 363(c)(2). Once that permission is granted, arguably a bank can freeze the account temporarily in order to get relief from the stay. But where the court has already given permission to use cash collateral, it is hard to believe there are any grounds for the stay to be lifted. Probably

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388 *In re* Cullen, 329 B.R. 52 (Bankr. N.D. Iowa 2005).

Strumpf is "dead on arrival" in chapters 7 and 11 insofar as trustees are concerned.

In the case of chapter 7 *debtors*, it should be readily apparent that *Strumpf* never applies. A debtor has no standing to seek sanctions (including damages) for control of estate property in violation of § 363(a)(3). Only the bankruptcy trustee has standing to seek sanctions and damages, when the issue is whether § 363(a)(3) was violated.

In chapter 7, the deposit account belongs to the bankruptcy estate, not to the debtor. If the bank refuses to honor debtor checks, the bank is doing precisely what it is supposed to do. The bankruptcy trustee is the only one who can order the bank to pay. Appropriately, some courts rule, in a chapter 7 case, that the debtor lacks standing to protest that an administrative hold violates the automatic stay.[389] This "standing" rule does not really turn on the meaning of § 362(a)(3).

There is one possibility of which depositary banks must be aware. Bankruptcy Code § 362(a)(6) prohibits "any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case under this title." There is no reference to "property of the estate" in § 362(a)(6), and so debtors would have standing to pursue damages for a violation of this provision.

Where the bank institutes a freeze without a countervailing setoff right and where the bank has some claim not suitable for setoff, the bank may find it has violated § 362(a)(6) because the freeze is motivated by a desire to collect a prepetition claim. This occurred in *Radcliffe v. International Painters & Allied Trades Independent Pension Fund (In re Radcliffe)*.[390] In *Radcliffe*, a corporation had underfunded a pension plan. The debtor, president of the corporation, issued a guaranty to the pension plan in order to make up the deficit. The debtor then retired (triggering the right to receive pension funds himself) and filed for bankruptcy. The fund withheld the pension by way of reimbursing the plan for the shortfall that the promissory note was designed to solve. The setoff, however, was held to violate the anti-alienation provisions in the plan, so that the pension plan's freeze was not in aid of protecting a setoff right. As a result, § 362(a)(7) did not apply, but § 362(a)(6) did—the freeze was an attempt to collect the prepetition promissory note issued by the debtor.[391]

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[389] Bucchino v. Wells Fargo Bank, N.A. (*In re* Bucchino), 439 B.R. 761 (Bankr. D.N.M. 2010); Wells Fargo Bank, N.A. v. Jimenez, 406 B.R. 935 (D.N.M. 2008).

[390] Radcliffe v. Int'l Partners & Allied Trades Ind. Pension Fund (*In re* Radcliffe), 372 B.R. 401 (Bankr. N.D. Ind. 2007).

[391] *Accord In re* Arnell, 2006 Bankr. LEXIS 3905 (Bankr. N.D. Ga. Dec. 26, 2006) (freeze of prepetition SFCU account constituted an attempt to collect a postpetition claim against the debtor).

In a similar spirit, § 362(a)(7) bars setoffs, and no mention of the bankruptcy estate is made. Does a debtor have standing to claim a § 362(a)(7) violation if the freeze is not temporary and therefore is a setoff? The answer is no. The setoff (if illegally manifested) is a harm to the trustee as owner of the deposit account. Since the debtor has no access to this account, the debtor has not been harmed if a setoff against the trustee's deposit account is wrongfully manifested.

In chapter 7 cases, it should be clear that the debtor has no standing to claim that an administrative freeze on the deposit account violates the automatic stay. Nevertheless, some courts disagree.

In *In re Weidenbenner*,[392] the court concluded that chapter 7 debtors *do* have standing to object to stay violations with regard to the debtor's deposit account. In *Weidenbenner*, a married couple filed a joint petition in chapter 7.[393] In their Schedule C, the debtors claimed the whole of these accounts as exempt.[394] Wells Fargo Bank placed an administrative hold on the debtors' deposit account.[395] As a result, some of the debtor's prepetition checks were dishonored (as properly they should have been). Thereafter, the trustee (rather generously) authorized the bank to honor the debtor's checks (perhaps anticipating that the deposit account contained exemptible funds).[396]

The court ruled that, by dishonoring checks, the bank had violated § 362(a)(3): "The court cannot think of a better example of 'control over property of the estate'"[397]—a statement in conflict with the *Strumpf* ruling that deposit accounts are not "property." The bank had justified its action because,

[392] *In re* Weidenbenner, 521 B.R. 74 (Bankr. S.D.N.Y. 2014).

[393] *See* 11 U.S.C. § 302.

[394] *In re* Weidenbenner, 521 B.R. at 77. The basis of the claim was the federal "wildcard" exemption of § 522(d)(5).

[395] *Id*. at 77–78. Apparently, it was the policy of the bank to freeze any deposit accounts that aggregated over $5,000. 521 B.R. at 78. The number $5,000 may have been chosen with an eye toward New York's Exempt Income Protection Act. Ch. 575, 2008 N.Y. Laws 4085, 4086 (codified as amended at N.Y. CPLR 5222, 5222-a, 5231, 5232). This act provides an individual debtor with a $2,500 exemption "[i]f direct deposit or electronic payments reasonably identifiable as statutorily exempt payments were made to the judgment debtor's account." N.Y. CPLR 4205(*l*)(1). As there were two debtors, they had access to $5,000 from their accounts. For details on this exemption, see David Gray Carlson, *Critique of Money Judgment (Pt. 3): Restraining Notices*, 77 ALB. L. REV. 1489, 1601–06 (2014). Of course, the debtors chose the federal exemption and so the CPLR would not be applicable. We speculate that Wells Fargo's standing policy was drafted with the CPLR in mind.

[396] *In re* Weidenbenner, 521 B.R. 74. We question, however, the lawfulness of the trustee's action. Surrendering the account to the debtor in anticipation of a successful exemption would seem to be a "sale" of property of the estate, which requires court permission. 11 U.S.C. § 363(b) Or perhaps it is an abandonment of estate property, which equally requires court permission. *Id*. § 554(a). No court permission was received, however, in *Weidenbenner*.

[397] *In re* Weidenbenner, 521 B.R. at 80.

under § 542(b), it had a duty to pay the trustee the amount of the deposit account. This claim the court rejected, ignoring the fact that a bank that knowingly honors postpetition presentment of debtor checks is not immunized by § 542(c) and therefore must reimburse the trustee.[398]

In any case, although the freeze benefitted the bankruptcy estate, the *Weidenbenner* court found the freeze to be a personal wrong to the debtors. This implies that the debtor may lawfully write checks on a deposit account prior to the account being exempted. In fact, the *Weidenbenner* court *expressly invited* debtors to write postpetition checks disabling banks from protecting the chapter 7 trustee:

> While the Court is sympathetic to Wells Fargo's argument that it has a duty under § 542(b) that could cause it to violate § 362(a), it can avoid this problem by simply waiting for the chapter 7 trustee to ask for the balance of any deposit accounts to be turned over. Once a petition is filed, debtors continue to eat, drive to work, and take care of children; they may not receive a post-petition paycheck for days or weeks. Wells Fargo's policy of freezing funds upon filing makes it more likely that debtors will squirrel away stashes of cash prior to filing so that they can continue to meet their everyday needs. By eliminating unlawful policies such as this one, debtors will be encouraged to use bank accounts post-petition and a more accurate record of a debtor's financial situation will be available in the form of bank statements. The trustee and the Court will be better able to see what a debtor is spending money on and can choose to admonish (or not to admonish) that debtor accordingly, under the guidance of the Bankruptcy Code.[399]

This passage makes a good point: chapter 7 is cruel and heartless. A chapter 7 debtor is initially denied access to exempt property, in order to accord creditors the opportunity to object to the exemption. Pending this substantial waiting period, the Bankruptcy Code provides no way for the debtor to live. In effect, the *Weidenbenner* court privileges a chapter 7 debtor to raid the bankruptcy

[398] 11 U.S.C. § 542(c) (2012). Judge Cecilia Morris criticized the bank's policy (not followed in the case at hand) to leave deposit accounts unfrozen where the balance was less than $5000. Judge Morris commented that "[t]his $5,000 threshold is completely arbitrary and simply does not conform to the plain language of § 542[(b)]." *In re* Weidenbenner, 521 B.R. at 80. But why mention this general policy when the debtor's balance was less than $5,000 and thus completely frozen? Perhaps in the next case the deposit account will be only $4,000 and the debtor's illegal checks will be honored. In that case, the *trustee* (not the debtor) will have a grievance. But in *Weidenbrenner* the bank's policy *not* to freeze in some cases is entirely irrelevant since the bank *did* freeze the account. Furthermore, accounts in excess of $5,000 *should* be frozen because that balance is owing to the bankruptcy trustee—not to the debtor.

[399] *See In re* Weidenbenner, 521 B.R. at 80.

estate in order to live—at least where the deposit account is ultimately exemptible.[400] Nevertheless, bankruptcy law could not be clearer that the deposit account belongs to the trustee *until* it is expelled from the bankruptcy estate pursuant to § 522(*l*).

Other courts assume without discussion that a chapter 7 debtor has standing to assert stay violations with regard to the deposit account.[401] Perhaps the high-water mark is *In re Cullen*,[402] which we have visited before. In *Cullen,* the debtor held a joint account with his father. None of the funds in the account belonged to the debtor and so the bank properly did not have a setoff right against this account. Nevertheless, the bank put a freeze on the account and the debtor was given standing to collect damages done to the *father* for this freeze. The justification of debtor standing was never discussed.[403]

6. Strumpf *and Exempt Property*

Many consumer deposit accounts are eventually exemptible in bankruptcy.[404] Until the exemption is claimed, however, the exemption does not exist. *All* of a debtor's property—including property exempt under state law—goes into the bankruptcy estate pursuant to § 541(a)(1). And even after the exemption is claimed, the creditors are entitled for some period of time to make objections. The exemption cannot be accomplished for many weeks after the chapter 7 bankruptcy petition is filed.[405]

Suppose, however, that the debtor claims a deposit account as exempt and no creditor objects. The deposit account is therefore successfully exempted, in the sense of being expelled from the bankruptcy estate. Suppose further that, after the deposit account is proclaimed exempt, the bank refuses to honor debtor checks. This can hardly be a violation of Bankruptcy Code § 362(a)(3) for two reasons. First, according to *Strumpf*, the deposit account is not "property." And second, even if it *is* property, it is no longer property *of the estate* but the debtor's own property. As to this "property," § 362(a)(3) no longer applies.

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400 *See also* Moreira v. Digital Employees Fed. Credit Union (*In re* Moreira), 173 B.R. 965, 973 (Bankr. D. Mass 1995) (chapter 7 debtor given standing because the debtor "may" claim the deposit account is exempt).

401 *In re* Schafer 315 B.R. 765 (Bankr. D. Colo. 2004).

402 *In re* Cullen, 329 B.R. 52 (Bankr. N.D. Iowa 2005).

403 11 U.S.C. § 522(*l*). Arguably, a case of violation of § 362(a)(6) could be made out. By denying the father access to his funds, the bank was trying to collect its counterclaim against the son. But this is doubtful, in that the freeze could also be motivated by protecting the rights of the bankruptcy trustee and was not calculated to get the debtor to make side payments to the bank out of postpetition property belonging to the debtor alone.

404 *In re* Schafer, 315 B.R. at 768–69.

405 *In re* Cullen, 329 B.R. 52.

The Ninth Circuit in *Mwangi v. Wells Fargo Bank N.A. (In re Mwangi)*,[406] reached this conclusion. In *Mwangi*, the deposit account became property of the estate in a chapter 7 case and was later exempted. The Ninth Circuit found that the debtors could plead no injury from any violation of the stay. While the account was property of the estate, the debtor had no right to use the account. When the account was exempted and expelled from the estate, § 362(a)(3) no longer applied because the deposit account ceased being property of the estate.

The question arises, however, whether the setoff right disappears once the deposit account is successfully exempted. At first blush, one is tempted to think that exemption is tested by whether a judicial lien attaches to the property.[407] A setoff right is obviously not a judicial lien.[408] How could exempt property be immune from the setoff? In addition, the Bankruptcy Code declares certain security interests against nonexempt property to be avoidable.[409] It does no such thing for setoff rights. Do not setoff rights survive exemption?

There are two lines of attack on the setoff for debtors. First, it can be said that, once the exemption occurs, a triangle arises. The setoff right, of course, depends on a prepetition mutual claim against the debtor held by a creditor who owes a prepetition debt to the debtor. After the bankruptcy petition, the trustee becomes the customer and the depositary bank's prepetition claim against the debtor is now a prepetition claim against the bankruptcy estate. But once the bank account is exempted, the mutual debts become triangular. The depositary bank owes the debtor personally, but the bank's claim is against the bankruptcy trustee.

There is a counter-argument, of course. What is exempted is the *net* deposit account after the setoff right is accounted for. Since a judicial lien creditor cannot reach the deposit account to the extent of the setoff right, the deposit account is only partly, not totally, exemptible.

Second, once it is exempted, the deposit account is no longer available to prepetition creditors of the debtor. According to Bankruptcy Code § 522(c):

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406 Mwangi v. Wells Fargo Bank N.A. (*In re* Mwangi), 764 F.3d 1168 (9th Cir. 2014).

407 11 U.S.C. § 522(b)(3)(A). Actually, the Bankruptcy Code provides no guidance for determining when property is exempt under nonbankruptcy law. In the case of tenancies by the entirety, slightly more help is given. The tenancy must be "exempt from process under applicable nonbankruptcy law . . . ."; *Id.* § 522(b)(3)(B). We presume that "exempt" means that a judicial lien may not attach to property under nonbankruptcy law.

408 *Id.* § 101(a)(36). A judicial lien is defined as "lien obtained by judgment, levy, sequestration, or other legal of equitable process of proceeding." *Id.*

409 *Id.* § 522(f)(1)(A). The security interests declared voidable are nonpurchase-money security interests on certain designated exempt items, such household furnishings and professional tools. *Id.*

> [P]roperty exempted under this section is not liable during or after the case for any debt of the debtor that arose . . . before the commencement of the case . . . .

This principle is subject to some enumerated exceptions. One of them is § 522(c)(2)—a debt that is "secured by a lien" that is not avoided under one of many avoidance provisions. A lien is defined as a "charge against . . . property to secure payment of a debt . . . ."[410] We read *Strumpf* as stating that a setoff exists in a two-person universe for which the deposit account is not "property." Rather, the setoff opportunity is a defense against a contractual obligation. As such it is not a lien. Thus, a possible side effect of *Strumpf* is that deposit account exemptions are free and clear of the depositary bank's setoff right.

Once again, the counter-argument is that only the deposit account net of the setoff opportunity is exemptible. If so, then § 522(c) is no impediment to the bank exercising a setoff right. Furthermore, if, as we suspect, the contract between bank and customer routinely creates a common law or an Article 9 security interest in the deposit account,[411] then the bank always qualifies for the "lien" exception to § 522(c), since "'security interest' means lien created by an agreement."[412] In such a case, the triangularity argument falls out of the equation.[413]

7. *Taking Scalia Seriously*

We have criticized many aspects of Justice Scalia's *Strumpf* opinion, but we have staunchly defended his holding that deposit accounts are not "property" within the meaning of § 362(a)(3). Some sources, however, do not take Justice Scalia at his word and assert that deposit accounts *are* property.

A deep theorist of bankruptcy law and "property" is Professor Thomas E. Plank, who, in a pair of articles,[414] argued a far larger consequence of *Strumpf* than we (or anyone else) are willing to endorse.[415] Professor Plank believes *Strumpf* overrules a seminal Supreme Court pronouncement, *United States v.*

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410 *Id*. § 101(a)(37).

411 *See, e.g., In re* Schafer, 315 B.R. 765, 769 (Bankr. Colo. 2004).

412 11 U.S.C. § 101(a)(51).

413 U.C.C. § 9-109(c)(13). Recall that the U.C.C. does not cover liens on consumer deposit accounts, U.C.C. § 9-109(c)(13).

414 Thomas E. Plank, *The Creditor in Possession under the Bankruptcy Code: History, Text, and Policy*, 59 MD. L. REV. 253 (2000); Thomas E. Plank, *The Outer Boundaries of the Bankruptcy Estate*, 47 EMORY L.J. 1193 (1998).

415 *See* Plank, *Creditor in Possession*, *supra* note 414, at 256 ("Courts and scholars have not yet appreciated the analytic significance of *Strumpf*").

Whiting Pools.[416] In *Whiting Pools*, a secured creditor had repossessed chemicals from a pool cleaning business. The debtor-in-possession sued for turnover of the chemicals. The secured creditor resisted on the theory that "property" means the debtor's interest in a thing (rather than the thing-in-itself). Since the prepetition debtor had no right to possess the chemicals as against the secured creditor, the debtor-in-possession's rights in the chemicals were limited to redeeming the chemicals (by paying the secured claim) and to receiving any cash surplus if the chemicals were sold. This, Professor Plank believes, is the "true" meaning of "property" as it is used in the Bankruptcy Code.

The Supreme Court, however, ruled that the chemicals (the "thing") were property and that the debtor-in-possession could obtain a turnover because the chemicals were useable under § 363(c)(1) in a reorganization proceeding.

Professor Plank believes that *Strumpf* overruled *Whiting Pools*. The meaning of *Strumpf*, in Plank's view, is that, in light of a bank's setoff right, the bankruptcy trustee had a property right in the deposit account after all — the right to receive the surplus above and beyond the setoff amount (if any). The setoff amount was *dehors* the bankruptcy estate.[417] In short, *Strumpf* changes the definition of "property" in the Bankruptcy Code to the one Professor Plank prefers.[418]

We believe Professor Plank's reading of *Strumpf* to be incorrect. Once again, Justice Scalia says, of § 362(a)(3), that the debtor's reliance on this provision:

> rests on the false premise that petitioner's administrative hold took something from respondent, or exercised dominion over property that belonged to respondent . . . . [The bank's] temporary refusal to pay was neither a taking of possession of respondent's property nor an

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416 United States v. Whiting Pools, 462 U.S. 198 (1983); *see* Plank, *Creditor in Possession*, *supra* note 414, at 258 (*Strumpf* "removed the logical underpinnings for the rationale of *Whiting Pools*. In a situation analogous to *Whiting Pools*, the court limited the meaning of 'property of the estate' to the specific definition in the Code. If the definition of property of the estate is so confined, section 542(a) cannot be read to give a reorganizing debtor in possession a right to turnover.").

417 Plank, *The Outer Boundaries*, *supra* note 414, at 1197 ("The Court ruled that the property of the estate consisted not of the money in the checking account but only of those rights in the account under the debtor's agreement with the bank, which rights were subject to the setoff rights of the bank").

418 *Id*. at 1256 (The Court correctly sees that property means "the interests of the debtor in property as of the commencement of the case. In *Strumpf*, those property interests . . . consisted of the rights that the debtor had under his contract with the bank . . . To the extent the bank had the right under the contract to exercise set off or an administrative hold . . . the debtor's contract right to withdraw moneys from the account was subject to the bank's contract right to set off. Therefore, the bank's administrative hold did not interfere with the debtor's contract rights, that is, with any interest of the debtor in the property.").

> exercising of control over it, but merely a refusal to perform its promise.[419]

On Professor Plank's reading of this passage, the trustee owns *some* rights in the deposit account—the right to receive a surplus after setoff. The bank owns some rights—the right to refuse payment to the extent of the setoff. If correct, this destroys the premise of our current Article—that Justice Scalia rightly invoked the two-universe regime of contract in holding that deposit accounts are not property at all. Thus, Professor Plank reaches his result by refusing to take Justice Scalia seriously—deposit accounts are "property" after all, even in a two-person universe.[420]

At least one court joins Professor Plank in refusing to take Justice Scalia at his word. Justice Scalia insisted that deposit accounts are not "property" in a two-person universe. As previously discussed,[421] the court in *Weidenbenner* held that failure to pay the debtor consisted of impermissible control of property of the bankruptcy estate. How can this be reconciled with *Strumpf*? According to the court:

> *Strumpf* is not applicable here. On its face, *Strumpf* is clearly limited to setoff rights. Wells Fargo is not a creditor and has no right to set-off . . . To read *Strumpf* more broadly would add an exception to the automatic stay that was clearly not contemplated by Congress. This Court is obligated to interpret the Code according to its plain meaning.[422]

In effect, the court held that Justice Scalia is not to be taken literally. Deposit accounts *are* property. They *cease to be property temporarily* when the bank acts to freeze its account in order to protect a setoff opportunity. On this view, *Strumpf* represents ad hoc judicial legislation designed to solve the banker's dilemma with regard to setoff. Where no setoff protection is on the scene, deposit accounts are *always* property.[423]

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419 Citizens Bank v. Strumpf, 516 U.S. 16, 21 (1995).

420 *But see* Thomas E. Plank, *Security Interests in Deposit Accounts, Securities Accounts, and Commodities Accounts: Correcting Article 9's Confusion of Contract and Property*, 69 OKLA. L. REV. 339 (2017). In this more recent article, Professor Plank writes:

> A deposit account is not a property item that can be owned. Indeed, the only person that has dominion over the deposit account is the bank, the obligor. The customer cannot possess or control a deposit account. Instead, the customer can own and control the rights arising from the deposit account relationship

*Id.*at 349. This seems eminently correct but is not reconciled with Professor Plank's prior work.

421 *See supra* text accompanying notes 392–400.

422 *In re* Weidenbenner, 521 B.R. 74, 81 (Bankr. S.D.N.Y. 2014).

423 *Accord* Calif. Empl. Dev. Dept. v. Taxel (*In re* Del Mission), 98 F.3d 1147 (9th Cir. 1996) (refusal to

We think, in contrast, that breach of contract is *never* control of debtor property, just as breach of contract does not consist of conversion by the defendant to his own use of the "property" that the plaintiff owns in the contract. On this point we find Justice Scalia on solid jurisprudential ground.

CONCLUSION

In *Citizens Bank v. Strumpf*,[424] Justice Scalia ruled that deposit accounts are not property. Although this seem counter-intuitive, we have defended this ruling as one that honors the distinction between contract and property. Contract exists in a two-person universe. A defendant that breaches her contract has not converted to her own use the plaintiff's property. Property exists in a three-or-more-person universe. When a deposit account is garnished, for example, the garnishor has a lien on the debtor's "property." Indeed, if one rejects the logic of *Strumpf* one would have to accept that all breaches of a contract by a debtor's counterparty are violations of § 363(a)(3)—an absurd result.

In *Strumpf*, the deposit account of the debtor became "property of the bankruptcy estate" within the meaning of Bankruptcy Code § 541(a)(1). At that point the bankruptcy trustee became the bank's customer. The trustee and the bank were "contractually" related. When the depositary bank froze the account, the depositary bank was (at best) in breach of contract and *not* in control of estate property within the meaning of § 362(a)(3). This, at least, was the case Justice Scalia *thought* he had before him, and on these supposed facts he was exactly correct. In fact, this was *far* from the real case before him, and we have explained at some length that, in *Strumpf*, there was neither a setoff, an automatic stay or even a "banker's dilemma" that needed to be solved.

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pay a debt for tax refund held a control of debtor property and a violation of the automatic stay); Allied Holdings, Inc. v. Volvo Parts N. Am., Inc. (*In re* Allied Holdings, Inc.), 2008 Bankr. LEXIS 3187 (Bankr. N.D. Ga. Oct. 31, 2008) (refusal to reimburse for overpayment of invoice held a violation of § 362(a)(3)). In *United States v. Harchar*, 371 B.R. 254 (N.D. Ohio 2007), the Internal Revenue Service refused to pay a tax refund to a chapter 13 debtor following plan confirmation. The IRS was to be paid in full under the plan (as chapter 13 requires). 11 U.S.C. § 1322(a)(2). The IRS withheld a tax refund otherwise due, just in case (as usually happens) the debtor did not complete the plan payments. The IRS argued that *Strumpf* immunizes it from the automatic stay—that refusal to pay a debt is not control over property. The *Harchar* court responded by pointing out that, whereas deposit accounts are not property, tax refunds *are*. And it could cite the Supreme Court for this proposition: "We conclude . . . that the Court of Appeals correctly held that the income tax refund [is] 'property' . . . ." Kokoszka v. Belford, 417 U.S. 642, 648 (1974). The case must be chalked up as one that does not take Justice Scalia at his word. Tax refunds are simply debts owed by the IRS, and debts are not property in a two-person world.

[424] *See* Citizens Bank v. Strumpf, 516 U.S. 16, 21 (1995).