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## Banks and Banking - Bank's Right of Set-Off-Deposit of Funds by a Fiduciary

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BANKS AND BANKING—BANK'S RIGHT OF SET-OFF—DEPOSIT OF FUNDS BY A FIDUCIARY—Plaintiff employed *A* as agent to sell plaintiff's tractor. *A* was to keep any amount received over \$5,000. *A* sold the tractor, receiving a \$6,120 check from the purchaser payable to *A*. *A* deposited the check in his personal checking account in defendant bank. Defendant took the deposit without knowledge of plaintiff's interests and applied it against a past due obligation of *A*. Plaintiff brought suit for \$4,500, the amount of checks from *A* to plaintiff which defendant refused to pay. The trial court held for defendant. On writ of error, *held*, reversed,<sup>1</sup> two judges dissenting. No equity was created in defendant superior to that of plaintiff, the beneficial owner of the deposit. *Cox v. Metropolitan State Bank*, 138 Colo. 576, 336 P. (2d) 742 (1959).

It is well settled that a bank has a right to apply the balance of a general deposit against a matured indebtedness of the depositor.<sup>2</sup> However, the authorities disagree as to whether the right exists when the funds deposited were held in a fiduciary capacity by the depositor. If the bank has notice of the fiduciary character of the funds, there is general accord that the bank

<sup>1</sup> There were two specially concurring opinions. Sutton, J., concurred on the ground that the funds were specially deposited as a matter of law. Frantz, J., concurred on the ground that the bank was merely an agent for collection.

<sup>2</sup> In *re Milwaukee Commercial Bank*, 236 Wis. 105, 294 N.W. 538 (1940); *Shuman v. Citizens State Bank*, 27 N.D. 599, 147 N.W. 388 (1914); *Irish v. Citizens' Trust Co.*, (N.D. N.Y. 1908) 163 F. 880. See 5A MICHIE, BANKS AND BANKING, perm. ed., §§164, 165 (1950).

does not have such a right.<sup>3</sup> But when the bank is without notice, there is a decided split of authority.<sup>4</sup> The majority of cases hold that here the right exists.<sup>5</sup> The minority hold that the right does not exist when the bank has no notice unless the bank has changed its position to its detriment.<sup>6</sup> The principal case, overruling two prior Colorado decisions<sup>7</sup> in order to side with the minority, demonstrates the need for more adequate analysis. An accurate analysis of the availability of the bank's right to apply a general deposit against the depositor's matured indebtedness requires first that the right be recognized as the right of set-off as distinguished from the banker's lien.<sup>8</sup> The banker's lien is a possessory right of security which attaches only to commercial paper deposited with the bank as bailee for the depositor in the regular course of business.<sup>9</sup> The bank's right of set-off, on the other hand, arises out of the debtor-creditor relationship which exists in the case of a general deposit.<sup>10</sup> Absent an agreement otherwise, a general deposit transfers title in the funds deposited to the bank, and the bank becomes the depositor's debtor for the amount deposited.<sup>11</sup> If the depositor is indebted to the bank on a matured obligation, the bank may extinguish

<sup>3</sup> *Sherfs v. Fulton Nat. Bank*, 342 Pa. 337, 21 A. (2d) 18 (1941); *Union Stock Yards Bk. v. Gillespie*, 137 U.S. 411 (1890); *Cable v. Iowa State Sav. Bank*, 197 Iowa 393, 194 N.W. 957 (1923). Notice can be given by facts sufficient to give actual knowledge or sufficient to put on inquiry. *Bank of Guntersville v. Crayter*, 199 Ala. 599, 75 S. 7 (1917).

<sup>4</sup> See cases collected in 50 A.L.R. 629 (1927); 31 A.L.R. 756 (1924); 13 A.L.R. 324 (1921).

<sup>5</sup> *Arnold v. San Ramon Valley Bank*, 184 Cal. 632, 194 P. 1012 (1921); *Shuman v. Citizens State Bank*, note 2 supra; *Kimmel v. Bean*, 68 Kan. 598, 75 P. 1118 (1904); *Smith v. Des Moines Nat. Bank*, 107 Iowa 620, 78 N.W. 238 (1899); *Hatch v. Fourth Nat. Bank*, 147 N.Y. 184, 41 N.E. 403 (1895). See also 2 TRUSTS RESTATEMENT SECOND §324, comment j (1959); 2 SCOTT, TRUSTS §324.4 (1956); 5A MICHIE, BANKS AND BANKING, perm. ed., §136 (1950).

<sup>6</sup> This is the so-called "federal" or "equitable" rule. *Agard v. Peoples Nat. Bank*, 169 Minn. 438, 211 N.W. 825 (1927), quoted at length in the principal case at 747; *Shotwell v. Sioux Falls Sav. Bank*, 34 S.D. 109, 147 N.W. 288 (1914). These cases claim the leading case of *Metropolis v. New England Bank*, 1 How. (42 U.S.) 234 (1843), affd. on second appeal 6 How. (47 U.S.) 212 (1848), as authority. But see note, 38 HARV. L. REV. 800 (1925). There is some authority to the effect that not even a change in position by the bank will allow it to prevail over the beneficial owner of the funds. *Burnett v. First Nat. Bank*, 38 Mich. 630 (1878). But cf. *Garrison v. Union Trust Co.*, 139 Mich. 392, 102 N.W. 978 (1905).

<sup>7</sup> Expressly overruling *Boettcher v. Colorado Nat. Bank*, 15 Colo. 16, 24 P. 582 (1890), and modifying the opinion in *Sherberg v. First Nat. Bank of Englewood*, 122 Colo. 407, 222 P. (2d) 782 (1950). But consider that out of seven judges, only three were content with the majority opinion. And cf. *Italian American Bank v. Carosella*, 81 Colo. 214, 254 P. 711 (1927), not mentioned in the opinions.

<sup>8</sup> See *Irish v. Citizens' Trust Co.*, note 2 supra. Many cases fail to recognize the distinction. The origin of the two rights are different. The banker's lien had its origin in the Law Merchant, while the right of set-off can be traced to the civil law. See note, 11 CALIF. L. REV. 111 (1922).

<sup>9</sup> See *Irish v. Citizens' Trust Co.*, note 2 supra. See also BROWN, PERSONAL PROPERTY, 2d ed., 577 (1955).

<sup>10</sup> *Kimmel v. Bean*, note 5 supra; *Shuman v. Citizens State Bank*, note 2 supra. In the case of a special deposit, where the bank is a bailee, the bank properly has a lien and not a right of set-off. 5A MICHIE, BANKS AND BANKING, perm. ed., §118 (1950).

<sup>11</sup> See, e.g., *White v. Pacific S. W. Trust and Sav. Bank*, (D.C. D.C. 1925) 9 F. (2d) 650, modified (9th Cir. 1934) 15 F. (2d) 300; *Shuman v. Citizens State Bank*, note 2 supra.

the mutuality of indebtedness by "setting off" its debt with the amount of the depositor's debt.<sup>12</sup> Set-off is well established as a protective right accorded to debtors.<sup>13</sup> It is not dependent upon the creditor's assent.<sup>14</sup> Thus, to determine accurately the availability of set-off to the bank, the assent of a depositor should not be required beyond the act of making a general deposit, by which the depositor objectively manifests<sup>15</sup> his assent to the transfer of title and the debtor-creditor relationship. It is well established that a transferee for value in good faith takes title to money<sup>16</sup> and negotiable instruments<sup>17</sup> free and clear of prior legal and equitable interests<sup>18</sup> of third parties. If the bank can qualify as a transferee for value of a general deposit when it has no notice of the depositor's fiduciary capacity, set-off should be available to the bank unimpaired by prior interests in the funds deposited. Standing alone, the act of crediting the depositor's account with the amount of the deposit does not constitute a giving of value by the bank.<sup>19</sup> However, if the bank extends credit to a general depositor without notice of the depositor's fiduciary capacity and in reliance upon having the right of set-off, the bank is protected even under the minority rule.<sup>20</sup> The bank has given value by extending credit.<sup>21</sup> But an antecedent debt also constitutes value. One who takes money or negotiable instruments in satisfaction of an antecedent debt is a transferee for value.<sup>22</sup> To the extent that the bank applies<sup>23</sup> a general deposit in good faith to discharge a depositor's debt via the right of set-off, the bank gives value for the deposit, and such an application should not later be defeated by third parties whose

<sup>12</sup> See note 2 supra.

<sup>13</sup> See note, 11 CALIF. L. REV. 111 (1922). Set-off is established by statute in many states.

<sup>14</sup> E.g., *Gunn v. Stock Yards State Bank*, 97 Kan. 404, 155 P. 796 (1916).

<sup>15</sup> See, e.g., *Gunn v. Stock Yards State Bank*, note 14 supra; *Meyers v. N.Y. County Nat. Bank*, 36 App. Div. 482, 55 N.Y.S. 504 (1899).

<sup>16</sup> The leading case is *Stephens v. Board of Education*, 79 N.Y. 183 (1879).

<sup>17</sup> The primary authority is NIL, §57. The transferee of a negotiable instrument must meet the requirements of a holder in due course as set out in NIL §52.

<sup>18</sup> Because the transferee who qualifies takes free of both legal and equitable interests, it makes no difference that the transferor was a trustee, bailee, agent, custodian, or thief.

<sup>19</sup> Cases are collected in BEUTEL'S BRANNAN, NEGOTIABLE INSTRUMENTS LAW, 7th ed., §25, p. 498 (1948). Note the cases *contra* cited therein at p. 499, and see comment, 33 YALE L.J. 628 (1924).

<sup>20</sup> The extension of credit is clearly a change in position within the meaning of the minority rule.

<sup>21</sup> "Value is any consideration sufficient to support a simple contract." From NIL, §25. 3 POMEROY, EQUITY JURISPRUDENCE, 5th ed., §747 (1941).

<sup>22</sup> *Swift v. Tyson*, 16 Pet. (41 U.S.) 1 (1842); *Stephens v. Board of Education*, note 16 supra; *Spaulding v. Kendrick*, 172 Mass. 71, 51 N.E. 453 (1898); NIL, §25. See also comment, 46 MICH. L. REV. 211 (1947); BEUTEL'S BRANNAN, NEGOTIABLE INSTRUMENTS LAW, 7th ed., §25, p. 514 (1948).

<sup>23</sup> Since a taker of security for an antecedent debt is usually a transferee for value, consideration should also be given to the possibility that the general deposit may be treated as security for an antecedent debt. See *Wood v. Boylston Nat. Bank*, 129 Mass. 358 (1880). This would move the time of giving of value up from the time of set-off to the time of deposit. If NIL, §27 protects the banker's lien on a special deposit from the time of deposit, should not the right of set-off be protected from the same time in the case of a general deposit? Cf. 2 TRUSTS RESTATEMENT SECOND §323, comment c (1959).

prior interests were unknown to the bank at the time of application.<sup>24</sup> The purpose of the rule that an antecedent debt is value is to augment the policy that commercial paper should circulate with maximum fluidity<sup>25</sup> by eliminating subjective inquiry into whether the transferee had changed his position on the antecedent debt.<sup>26</sup> In view of the uniform recognition that an antecedent debt is value, the requirement of the minority view that the bank prove a change in position despite the existence of the depositor's antecedent debt seems inappropriate. Since this area fairly demands a greater degree of predictability, it is hoped that more adequate recognition will be given to the bank's qualifications as a transferee for value in good faith when the bank's right of set-off is threatened by prior interests of third parties.

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<sup>24</sup> See the cases cited in note 5 supra.

<sup>25</sup> This is the policy underlying the corpus of the law of transfer of commercial paper. *Miller v. Race*, 1 Burr. 452, 97 Eng. Rep. 398 (1758); *Stephens v. Board of Education*, note 16 supra.

<sup>26</sup> Strahorn, "The Policy or Function of the Law of Bills and Notes, Part II," 87 UNIV. PA. L. REV. 793 at 795 (1939). See also *Swift v. Tyson*, note 22 supra; comment, 33 YALE L.J. 628 (1924).