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BANKRUPTCY LAW

BANK'S RIGHT OF SET-OFF UNDER THE BANKRUPTCY ACT

New Jersey National Bank v. Gutterman (In re Applied Logic Corp.)

Section 68a of the Bankruptcy Act provides that where "mutual debts or credits [exist] between the estate of a bankrupt and a creditor . . . one debt shall be set off against the other, and the balance only shall be allowed or paid."¹ Under section 68a,² a bank

¹ Bankruptcy Act § 68, 11 U.S.C. § 108 (1976), provides:

(a). In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.

(b). A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subdivision (g) of section 93 of this title [section 57 of the Act]; or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

The requirement of an "account stated" is satisfied by the existence of "an agreement between the parties to an account based upon prior transactions between them." *Dwyer v. Franklin (In re Majestic Radio and Tel. Corp.)*, 227 F.2d 152, 157 (7th Cir. 1955), *cert. denied*, 350 U.S. 995 (1956) (quoting 1 AM. JUR. *Accounts and Accounting* § 16 (1938)). The "mutuality" requirement is met when "the debts or credits [are] in the same right and between the same parties, standing in the same capacity." 4 W. COLLIER, *BANKRUPTCY* ¶ 68.04 [2.1] (14th ed. 1978); *accord*, 3 H. REMINGTON, *A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES* § 1443 (rev. ed. J. Henderson 1956); *see* *Baruch Inv. Co. v. Danning*, 521 F.2d 186, 190 (9th Cir. 1975); *In re Alfar Dairy, Inc.*, 458 F.2d 1258 (5th Cir.), *cert. denied*, 409 U.S. 1248 (1972). The "allowability" requirement is embodied in § 57g of the Bankruptcy Act, 11 U.S.C. § 93(g) (1976), which provides that a creditor's claims against the bankrupt's estate are "allowed" only when any preferences received or acquired by the creditor are surrendered. *Katchen v. Landy*, 382 U.S. 323 (1966); *see* 4 W. COLLIER, *supra*, ¶ 68.08; 2 H. REMINGTON, *supra*, § 762. Finally, § 57 of the Act, 11 U.S.C. § 93 (1976), sets forth detailed requirements and procedures concerning the "provability" of claims. Generally, a claim must be "provable in its nature at the time when the set-off is claimed, not provable in the pending bankruptcy proceedings." *Morgan v. Wordell*, 178 Mass. 350, 351, 59 N.E. 1037, 1038 (1901). For additional background material concerning statutory set-off, *see* *Otte v. United States*, 419 U.S. 43, 54-55 (1974); *Sun Basin Lumber Co. v. United States*, 432 F.2d 48 (9th Cir. 1970); *Wilson v. Hy-Lan Furniture Co.*, 332 F.2d 284 (4th Cir.) (per curiam), *cert. denied*, 379 U.S. 946 (1964); *In re Tyner*, 301 F. Supp. 1234 (M.D. Ga. 1969). *See generally* 4 W. COLLIER, *supra*, ¶ 68; D. COWANS, *BANKRUPTCY LAW AND PRACTICE* § 501 (2d ed. 1978); 1 *LAWYERS CO-OPERATIVE, MODERN BANKRUPTCY MANUAL* §§ 509-527 (1966); 3 H. REMINGTON, *supra*, §§ 1431-1487.

The right of set-off described in the statute should be distinguished from the analogous devices of recoupment and counterclaim. A set-off ordinarily involves mutual debts or credits arising from different transactions and is utilized to reduce or extinguish the claim of a creditor. *See* 4 W. COLLIER, *supra*, ¶ 68.03. Recoupment, which also is used to reduce a claim, involves the assertion of a demand by a defendant arising from the same transaction. *E.g.*, *In re Monongahela Rye Liquors, Inc.*, 141 F.2d 864, 869 (3d Cir. 1944); *In re Tele King Corp.*, 136 F. Supp. 731, 732 (S.D.N.Y. 1955). Counterclaim, on the other hand, is a much broader device which enables a party to obtain affirmative relief. *E.g.*, *In re Monongahela Rye*

may set off a debt owed it by a bankrupt depositor against the bankrupt's deposits,³ since the deposits establish a debtor-creditor relationship between the bank and the depositor.⁴ Although past legislative attempts to limit the bank's right to set-off have failed,⁵ the courts on occasion have devised doctrines to limit the bank's right of set-off⁶ in an apparent effort to achieve one of the prime objectives of the Bankruptcy Act: equitable distribution of the bankrupt's assets among creditors.⁷ In cases where the financial institution is deeply involved in the affairs of the bankrupt and its creditors, some courts have denied the bank's attempt to assert its set-off right by invoking theories of equitable estoppel⁸ or implied waiver.⁹ Recently, however, in *New Jersey National Bank v. Gutterman (In re Applied Logic Corp.)*,¹⁰ the Second Circuit expressed a reluctance to recognize these exceptions to the set-off rule and held that a bank which had played a major role in formulating refinancing agreements with the bankrupt and other creditors and had monitored the financial status of the bankrupt could not, without more, be denied its right of set-off.¹¹

In re Applied Logic Corp. concerned a New Jersey-based com-

Liquors, Inc., 141 F.2d 864, 869 (3d Cir. 1944); see 4 W. COLLIER, *supra*, ¶ 68.03, 3 MOORE'S FEDERAL PRACTICE ¶ 13.02 (2d ed. 1974).

² The set-off doctrine originated in Roman law and was embodied in the earliest American bankruptcy laws. See generally 4 W. COLLIER, *supra* note 1, ¶ 68.01; 3 H. REMINGTON, *supra* note 1, § 1431; Lloyd, *The Development of Set-Off*, 64 U. PA. L. REV. 541 (1916). For a historical overview of bankruptcy in America, see C. WARREN, *BANKRUPTCY IN UNITED STATES HISTORY* (1935).

³ E.g., *New York County Nat'l Bank v. Massey*, 192 U.S. 138 (1904); see 4 W. COLLIER, *supra* note 1, ¶ 68.16; D. COWANS, *supra* note 1, § 501; 3 H. REMINGTON, *supra* note 1, §§ 1472-1486.

⁴ *New York County Nat'l Bank v. Massey*, 192 U.S. 138 (1904); *Scammon v. Kimball*, 92 U.S. 362 (1875). In *Massey*, the Supreme Court stated that "a deposit of money upon a general account creates . . . an ordinary debt, not a privilege or a right of a fiduciary character." 192 U.S. at 145 (citations omitted).

⁵ See note 33 and accompanying text *infra*.

⁶ See note 27 and accompanying text *infra*.

⁷ Section 65a of the Bankruptcy Act, 11 U.S.C. § 105(a) (1976), specifically provides that the bankrupt's estate is to be divided equally among creditors. Equality among creditors has long been recognized as a primary objective of the bankruptcy laws. See, e.g., *Sampsell v. Imperial Paper Corp.*, 313 U.S. 215, 219 (1941). See generally 3 W. COLLIER, *supra* note 1, ¶ 60.01, at 743-44; see also *Moore v. Bay*, 284 U.S. 4, 5 (1931).

⁸ *Union Bank & Trust Co. v. Loble*, 20 F.2d 124 (9th Cir.), *cert. denied*, 275 U.S. 545 (1927); see note 27 and accompanying text *infra*.

⁹ *First Nat'l Bank v. Dudley*, 231 F.2d 396 (9th Cir. 1956); *Union Trust Co. v. Peck*, 16 F.2d 986 (4th Cir.), *cert. denied*, 273 U.S. 767 (1927); see notes 27-29 and accompanying text *infra*.

¹⁰ 576 F.2d 952 (2d Cir. 1978), *rev'g* [1977-78 Transfer Binder] *BANKR. L. REP.* (CCH) ¶ 66,630 (S.D.N.Y. 1977), *aff'g* 11 *Collier Bankr. Cas.* 194 (Bankr. Ct. S.D.N.Y. 1976).

¹¹ 576 F.2d at 960.

puter business, Applied Logic Corporation (ALC), which owed large sums to several creditors and banks, including New Jersey National Bank (NJNB).¹² In an effort to rectify the ailing corporation's financial condition, ALC, NJNB and various other creditors participated in two consecutive refinancing agreements under which ALC was obligated to "conduct all banking of its funds at and through New Jersey National Bank."¹³ Pursuant to the second agreement, ALC's board of directors was reorganized to give majority representation to the non-bank creditors, and one directorship to NJNB as representative of all the creditor-banks.¹⁴ ALC continued to deposit monies into a general demand checking account in NJNB.¹⁵ When ALC attempted to transfer a \$100,000 certificate of deposit to another bank, NJNB withdrew its vice president from the ALC board and accelerated the corporation's debt.¹⁶ Subsequently, NJNB set off funds from the general account against the balance due on its unsecured loan to ALC.¹⁷

In 1975, a bankruptcy proceeding was commenced in which the validity of the bank's set-off was challenged.¹⁸ Noting that "the right to set off given by section 68(a) has consistently been held to be

¹² *Id.* at 954. ALC owed a total of \$1,300,000 to four banks and \$2,000,000 to several lessors of computer equipment. *Id.*

¹³ *Id.* at 954-55.

¹⁴ *Id.* at 955. Under the terms of the second agreement, ALC was required to report monthly to the banks concerning the status of its accounts receivable, and "any creditor could declare his debt to be immediately due and payable if ALC failed to meet specified cash flow goals, if it failed to raise the full \$500,000 working capital required by the agreement or under other specified conditions." *Id.* In addition, a special account into which ALC was to have made monthly payments was to be established with the New Jersey National Bank (NJNB). The special account was never created, however, because the new board of directors decided that it would be more expeditious to permit ALC to pay creditors directly. *Id.* It should be noted that had this account been established, it probably would not have been subject to the bank's § 68 right of set-off. For a discussion of the "special deposit" exception to the rule permitting the set-off of bank deposits, see note 44 and accompanying text *infra*.

¹⁵ 576 F.2d at 955. Although NJNB had the right to inquire into all withdrawals, it exercised this right on only two or three occasions.

¹⁶ *Id.* at 956. When the amount of the funds deposited in the general account exceeded \$100,000, NJNB would invest the monies in its own certificates of deposit, with the approval of ALC. *Id.* In June 1974, ALC requested permission to transfer a certificate of deposit to the Princeton National Bank, which maintained the company's payroll account. *Id.* at 956.

¹⁷ *Id.* Approximately \$240,000 of ALC's deposits were set off by NJNB prior to ALC's filing of its petition under Chapter XI, Bankruptcy Act §§ 301-399, 11 U.S.C. §§ 701-799 (1976). An additional \$30,000 was set off after the petition had been filed.

¹⁸ *Id.* ALC filed its petition in bankruptcy on Mar. 27, 1975 and was adjudicated a bankrupt on Aug. 10, 1976. NJNB filed a complaint pursuant to Part VII of the Bankruptcy Rules, 11 U.S.C. rules 701-782 (1976), seeking a declaration of the validity of a lien on ALC's assets based upon an independently negotiated secured note. See note 26 *infra*. ALC answered and counterclaimed that NJNB's set-offs were invalid under § 68a of the Bankruptcy Act, 11 U.S.C. § 108(a) (1976), and constituted voidable preferences under § 60, 11 U.S.C. § 96 (1976).

within the discretion of the Bankruptcy Court," the bankruptcy court judge held that NJNB's participation in the financial affairs of ALC was sufficient to impress the character of a trust upon the general deposits and estop the bank from setting off those funds.¹⁹ On appeal, the district court affirmed.²⁰

In reversing, Judge Friendly, writing for a unanimous panel,²¹ conceded that "equality among creditors [is a] dominant impulse" in the law of bankruptcy, but observed that the "dominant impulse" underlying the Bankruptcy Act's set-off provision is "inequality among creditors."²² In light of this policy, Judge Friendly emphasized the need to be "circumspect . . . in carving out exceptions to the express language of § 68."²³ Turning to the facts, the court noted that all of the parties to the refinancing agreements were "highly sophisticated extenders of credit," who could have demanded an express waiver if it had been their intention that NJNB refrain from exercising its right of set-off.²⁴ Moreover, the ambiguous testimony of one NJNB official was deemed insufficient as a matter of law to support a finding that the other parties to the refinancing agreements had relied to their detriment on "assurances" that NJNB would not exercise its set-off right.²⁵ While

¹⁹ 11 Collier Bankr. Cas. at 199 (citing *First Nat'l Bank v. Dudley*, 231 F.2d 396 (9th Cir. 1956)); see *Cumberland Mfg. Co. v. De Witt*, 237 U.S. 447, 455 (1915).

²⁰ [1977-78 Transfer Binder] BANKR. L. REP. (CCH) ¶ 66,630 (S.D.N.Y. 1977).

²¹ Judges Mulligan and Meskill joined in the unanimous decision.

²² 576 F.2d at 957 (citing *New York County Nat'l Bank v. Massey*, 192 U.S. 138, 148 (1904)); 4 W. COLLIER, *supra* note 1, ¶ 68.01[3], at 846-48, 3 H. REMINGTON, *supra* note 1, §§ 1434-1435.

²³ 576 F.2d at 961. The great weight of authority supports the view that the right of set-off under § 68a is permissive rather than mandatory. See *Cumberland Glass Mfg. Co. v. De Witt*, 237 U.S. 447, 455 (1915). The *Cumberland* Court stated that the question whether a set-off should be allowed "is placed within the control of the bankruptcy court, which exercises its discretion . . . upon the general principles of equity." *Id.* (citations omitted). The *Cumberland* view has been followed in a great number of cases. See, e.g., *Brunswick Corp. v. Clements*, 424 F.2d 673, 675 (6th Cir. 1970), *cert. denied*, 400 U.S. 1013 (1971); *Tucson House Constr. Co. v. Fulford*, 378 F.2d 734 (9th Cir. 1967); *In re Monongahela Rye Liquors, Inc.*, 141 F.2d 864, 869 (3d Cir. 1944); *Prudential Ins. Co. v. Nelson*, 101 F.2d 441 (6th Cir.), *cert. denied*, 308 U.S. 583 (1939); *Stanolind Oil & Gas Co. v. Logan*, 92 F.2d 28 (5th Cir. 1937), *cert. denied*, 302 U.S. 763 (1938); *Lehigh Valley Coal Sales Co. v. Maguire*, 251 F. 581 (7th Cir. 1918).

²⁴ 576 F.2d at 961.

²⁵ *Id.* Judge Friendly noted that the lower courts had relied largely upon the testimony of Mr. Lynch, an NJNB official who stated that "if the agreement was put together and signed and we didn't have a past due note at that time, we had no way to set off. So whether we wanted to or not we couldn't." *Id.* at 960 n.18. Observing that Mr. Lynch's statement more reasonably could have been interpreted by the other creditors as an indication that NJNB intended to set off the funds when ALC's indebtedness became past due, Judge Friendly concluded that the lower court's finding of reliance was "clearly erroneous." *Id.* The "clearly

not explicitly holding that the right of set-off is "mandatory," the court concluded that it would "require far more convincing evidence" to preclude a bank from exercising its right of set-off.²⁶

The *Applied Logic* court's decision to uphold NJNB's right of set-off, despite its deep involvement in the affairs of a financially ailing depositor, brings the Second Circuit into direct conflict with the position advanced by the Ninth Circuit in *First National Bank v. Dudley*.²⁷ Confronted with facts similar to those presented in

erroneous" standard is embodied in Bankruptcy rule 810, 11 U.S.C. rule 810 (1976), which provides:

Upon an appeal the district court may affirm, modify, or reverse a referee's judgment or order, or remand with instructions for further proceedings. The court shall accept the referee's findings of fact unless they are clearly erroneous, and shall give due regard to the opportunity of the referee to judge of the credibility of the witnesses.

This restriction also applies when the court of appeals reviews a determination of the district court. *Smith v. Federal Land Bank*, 150 F.2d 318, 321 (9th Cir.), cert. denied, 326 U.S. 764 (1945); *Kauk v. Anderson*, 137 F.2d 331, 333 (8th Cir. 1943); *Morris Plan Indus. Bank v. Henderson*, 131 F.2d 975, 976 (2d Cir. 1942); FED. R. CIV. P. 52a. See generally 2 W. COLLIER, supra note 1, ¶ 39,28.

²⁶ 576 F.2d at 961. The court also resolved a related dispute concerning the application of ALC's assets to the satisfaction of a secured note held by NJNB. *Id.* at 964-65. In 1971, NJNB had given ALC a \$100,000 loan secured by all of ALC's unencumbered assets. *Id.* at 955. During the bankruptcy proceedings, NJNB had claimed that \$56,862.93 of the principal of the secured loan remained unpaid. *Id.* at 956. Relying on a provision of one of the refinancing agreements, the bankruptcy court judge determined that, even if NJNB's set-offs were valid, the deposits in question had to be applied first against the secured indebtedness. *Id.* The effect of this determination was to minimize NJNB's total recovery against the estate of the bankrupt. Finding that the bankruptcy court judge had "overread" the provision in the refinancing agreement, Judge Friendly held that NJNB was within its right to apply the bank deposits in the most advantageous manner "without regard to the interests of the debtor." *Id.* at 965 (quoting 15 S. WILLISTON, LAW OF CONTRACTS § 1796 (3d ed. 1972)).

²⁷ 231 F.2d 396 (9th Cir. 1956). The implied waiver doctrine, rejected in *Applied Logic*, was first advanced by the Fourth Circuit in *Union Trust Co. v. Peck*, 16 F.2d 986 (4th Cir.), cert. denied, 273 U.S. 767 (1927). In *Peck*, a bank entered into agreements with several other creditors in an effort to keep its bankrupt customer afloat. 16 F.2d at 987-88. On the basis of these express agreements, the Fourth Circuit found an implied agreement that no party would "do anything to secure preferential rights in or over any assets of the bankrupt." *Id.* at 988. The *Peck* case was followed by the Ninth Circuit in *Union Bank & Trust Co. v. Loble*, 20 F.2d 124 (9th Cir.), cert. denied, 275 U.S. 545 (1927). In *Loble*, the bankrupt made a special sale of its inventory after consulting with its bank to raise sufficient funds to pay certain creditors and to assist the bankrupt in continuing its business. The proceeds from the sale were deposited in the depositor's general account and subsequently set off by the bank. 20 F.2d at 125. The *Loble* court concluded that the bank should be estopped from asserting its right of set-off against the account since the circumstances surrounding its creation were sufficient "to impress upon it the character of a trust fund." *Id.* In two subsequent cases, the *Loble* decision was given a narrow interpretation. *Killoren v. First Nat'l Bank*, 127 F.2d 537, 543 (8th Cir. 1942); *Citizen's Nat'l Bank v. Lineberger*, 45 F.2d 522, 530 (4th Cir. 1930). The doctrine, however, was reaffirmed and expanded by the Ninth Circuit in *First Nat'l Bank v. Dudley*, 231 F.2d 396 (9th Cir. 1956).

Applied Logic,²⁸ the *Dudley* court held that a bank which had participated in a refinancing agreement involving the bankrupt and other creditors may impliedly waive its set-off right and thereby be estopped from asserting it.²⁸ It is submitted, however, that the Second Circuit's holding in *Applied Logic* represents the better view.

The primary purpose of the set-off provision in the Bankruptcy Act is to prevent unfairness to the bankrupt's debtors, who otherwise would be required to repay the bankrupt's estate in full while receiving only partial satisfaction on any claims they might have against the estate.³⁰ Underlying this specific purpose is a more general federal policy of encouraging the rehabilitation of faltering enterprises wherever possible.³¹ Section 68a clearly supports this policy by encouraging banks to continue to transact business with and extend credit to insolvent businesses without fear of losing their ability to minimize potential losses through the exercise of the right of set-off.³²

²⁸ In *Dudley*, a debtor negotiated an arrangement to liquidate its inventory over a 12-month period and from the proceeds pay its bank and other creditors 10% of its debts in monthly installments. 231 F.2d at 399. The debtor was to maintain an account with the bank which in turn agreed to refrain from demanding immediate full payment of the monies due it. *Id.* The debtor ultimately defaulted on its monthly payments, however, and the bank offset the deposits remaining in the account. *Id.* at 400.

²⁹ *Id.* at 402. In examining the applicability of the doctrine of equitable estoppel, the *Dudley* court quoted former Chief Justice Stone: "The court of bankruptcy is a court of equity . . . and it is for that court . . . to define and apply federal law in determining the extent to which the inequitable conduct of a claimant in acquiring or asserting his claim . . . requires its subordination . . ." *Id.* (quoting *Prudence Realization Corp. v. Geist*, 316 U.S. 89, 95 (1942)). The *Dudley* majority then concluded that the facts before it justified the application of equitable principles to deny the bank's right of set-off. 231 F.2d at 402.

³⁰ *United States v. Brunner*, 282 F.2d 535 (10th Cir. 1960); see, e.g., *D. COWANS*, *supra* note 1, § 501 at 122.

³¹ See, e.g., *Wright v. Union Cent. Life Ins. Co.*, 304 U.S. 502, 514 (1938).

³² See, e.g., *Studley v. Boylston Nat'l Bank*, 229 U.S. 523, 529 (1913); *Katz v. First Nat'l Bank*, 368 F.2d 964, 972-73 (2d Cir. 1977) (Van Graafeiland, J., concurring in part and dissenting in part), *cert. denied*, 434 U.S. 1069 (1978); *First Nat'l Bank v. Dudley*, 231 F.2d 396, 403-04 (9th Cir. 1956) (Pope, J., dissenting). Recognition of the need to encourage banks to assist faltering businesses was expressed by the Supreme Court in the *Studley* case. *Studley* involved a challenge to a set-off exercised by a bank which had knowledge of the bankrupt's insolvency at the time it accepted the deposits in question. 229 U.S. at 524. In holding that the bank's set-offs were valid, the Court observed that "to deny the right of set-off, in cases like this, would in many cases make banks hesitate to honor checks given to third persons, would precipitate bankruptcy and so interfere with the course of business as to produce evils of serious and far reaching consequences." *Id.* at 529. The same consideration was acknowledged in the dissenting opinion in *First Nat'l Bank v. Dudley*, 231 F.2d 396, 404 (9th Cir. 1956) (Pope, J., dissenting):

The type of arrangement here attempted was designed to accomplish a useful object—to get a faltering business on its feet, all to the end that ultimately all creditors may be paid, and the owner save his business . . . Such attempts, I think, should be encouraged. But from now on no bank, creditor of such a debtor,

The importance of the set-off rule, particularly as it applies to banks, was recognized as early as the 1930's, when Congress passed comprehensive bankruptcy reform measures to address some of the more serious economic problems arising out of the Depression.³³ During the course of the legislative debates preceding the 1938 enactment of the Chandler Act, it was suggested that limitations be placed on a bank's right of set-off.³⁴ Proponents of such limitations contended that banks enjoyed an undeservedly preferential position among creditors.³⁵ The banks, however, pointed out that restrictions on their set-off privileges might discourage them from extending credit to financially unstable businesses and thereby defeat the rehabilitative goals of the Act.³⁶ In apparent recognition of the key role

will dare to agree to "go along," on such a plan, because if it should fail, and bankruptcy follow, as here, the bank would risk being held to have waived its right of set-off.

³³ In 1938 major efforts to revise and modernize the bankruptcy laws culminated in the enactment of the Chandler Act. Act of June 22, 1938, Pub. L. No. 699, §§ 1-702, 52 Stat. 840. Based upon emergency legislation enacted during the Depression, see 1 W. COLLIER, *supra* note 1, ¶ 0.06, the Chandler Act revised virtually all of the rehabilitative provisions of the bankruptcy laws and introduced the arrangement and reorganization chapters of the Act. See 11 U.S.C. §§ 500-926 (1976). See generally McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369 (1937); Weinstein, *The Debtor Relief Chapters of the Chandler Act*, 5 U. PRR. L. REV. (1938).

³⁴ When the bill which later became the Chandler Act was originally introduced as H.R. 12889, 74th Cong., 2d Sess. (1936), § 68 contained three additional subdivisions affecting banks. Proposed subdivision (d) provided:

A deposit by a bankrupt in a bank to which he is indebted at the time shall be deemed a voidable preference if made under such circumstances that a transfer at such time by the bankrupt to the bank would constitute a voidable preference under this Act

Id. § 68(d); see 4 W. COLLIER, *supra* note 1, ¶ 68.01, at 845. The effect of subdivision (d) would have been to deprive a bank of its right of set-off against deposits made under circumstances that would otherwise result in a voidable preference under § 60 of the Act, 11 U.S.C. § 96 (1976). For a discussion of the distinction between bank deposits and "transfers" under § 60 of the Act, see note 42 *infra*. A modified version of proposed subdivision (d) subsequently was introduced to overrule *Continental & Commercial Trust & Savs. Bank v. Chicago Title & Trust Co.*, 229 U.S. 435 (1913), in which the Supreme Court held that knowledge of a depositor's insolvency does not defeat a bank's right of set-off. The proposed provision would have limited a bank's right of set-off where a bank has acquired "reasonable cause to believe that the bankrupt is insolvent." *House Hearings on H.R. 6439*, 75th Cong., 1st Sess. 205-06 (1937).

³⁵ See McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369 (1937); McLaughlin, *Amendment of the Bankruptcy Act*, 40 HARV. L. REV. 583, 600-04 (1927). Professor McLaughlin argued that banks should not be permitted to profit from deposits accepted after the bank has acquired knowledge of its customer's insolvency. See *House Hearings on H.R. 6439*, 75th Cong., 1st Sess. 150-52 (1937).

³⁶ See *House Hearings on H.R. 6439*, 75th Cong., 1st Sess. 153-54 (1937). The banking institutions pointed out that banks often rely on a customer's deposits as additional security for extending credit in instances where the customer is experiencing financial difficulties. The restrictions in the proposed subdivision, the banks argued, could seriously restrict bank credit. Furthermore, it was noted that, unlike trade creditors whose accounts receivable often

that banks play in the financial stability of some businesses, Congress chose to leave the set-off right intact.³⁷ Although a recent overhaul of the federal bankruptcy statute has resulted in substantial changes,³⁸ the right of set-off has not been significantly restricted.³⁹ Moreover, Congress did not incorporate the *Dudley* ex-

have substantial profit margins, banks receive only a small percentage of profit on each loan they make. For this reason, the banks contended, financial institutions rely on the right of set-off to help mitigate their losses in cases where the customer defaults. *Id.*

³⁷ The proposal to limit a bank's right to set off bank deposits was deleted from the final version of the Chandler Act, H.R. 8046, 75th Cong., 1st Sess. (1937), before it was enacted in 1938. Act of June 22, 1938, Pub. L. No. 696, §§ 1-702, 52 Stat. 840; see 1 W. COLLIER, *supra* note 1, ¶ 0.07; ¶ 68.01 4 *id.*, at 848.

³⁸ See S. REP. No. 95-989, 95th Cong., 2d Sess. 1-4, reprinted in [1978] U.S. CODE CONG. & AD. NEWS 3, 3-7 [hereinafter cited as S. REP. No. 95-989; U.S. CODE]. On Oct. 1, 1979, the substantive provisions of the revised Bankruptcy Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, become effective. The remaining sections which outline the new bankruptcy court system, become effective Oct. 1, 1984. The Act represents the culmination of nearly a decade of efforts to reform the bankruptcy laws. See S. REP. No. 95-989, *supra*, at 1-4, U.S. CODE at 3-7. The new set-off provision is embodied in § 553 of the Act of 1978. 11 U.S.C.A. § 553 (West Supp. Pam. 1979).

³⁹ See S. REP. No. 95-989, *supra* note 38, at 91-92, U.S. CODE at 93-94; H.R. REP. No. 95-595, 95th Cong., 1st Sess. 184-86 (1977), reprinted in [1978] U.S. CODE CONG. & AD. NEWS 179, 363-65 [hereinafter cited as H.R. REP. No. 95-595, U.S. CODE]. The status of the set-off right under the Act of 1978 is described in S. REP. No. 95-989 as follows:

[t]he [set-off] section states that the right of set-off is unaffected by the [new] bankruptcy code except to the extent that the creditor's claim is disallowed, the creditor acquired (other than from the debtor) the claim during the 90 days preceding the case while the debtor was insolvent, the debt being offset was incurred for the purpose of obtaining a right of set-off, while the debtor was insolvent and during the 90-day prebankruptcy period, or the creditor improved his position in the 90-day period . . . Only the last exception is an addition to current law.

Id. at 91-92, U.S. CODE at 93-94.

The new limitation on the set-off right as it appears in § 553 precludes banks from setting off deposits of insolvent customers made within a 90-day period preceding the filing of the petition in bankruptcy, to the extent that such deposits increase the amount in the account to a level in excess of that which existed immediately before the commencement of the 90-day period. 11 U.S.C.A. § 553(b) (West Supp. Pam. 1979); see H.R. REP. No. 95-595, *supra*, at 184-86, U.S. CODE at 361-63.

It should be noted that there is some indication that the redefined "transfer" term, 11 U.S.C.A. § 101(40) (West Supp. Pam. 1979), of the Act of 1978 is intended to embrace "bank deposits." See S. REP. No. 95-989, *supra* note 38, at 27, U.S. CODE at 29. So defined, bank deposits would seemingly be subject to scrutiny under the new section addressing voidable preferences. 11 U.S.C.A. § 547 (West Supp. Pam. 1979); see note 42 *infra*. Thus, a long line of cases which held that bank deposits do not constitute transfers under the bankruptcy laws apparently would be overruled. See, e.g., *Katz v. First Nat'l Bank*, 568 F.2d 968, 971 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); note 42 *infra*. Although this change could be viewed as an indication of Congress' intent to limit the bank's right of set-off, a contrary intent—to continue encouraging banks to assist faltering businesses and impose only minimal new limitations on the set-off right—was expressed in the final House Report on the Act of 1978. See H.R. REP. No. 95-595, *supra*, at 184-86, U.S. CODE at 361-63. In addition, since § 547, the new voidable preferences provision appears to be inapplicable to transfers made "in the ordinary course of business," 11 U.S.C.A. § 547(c)(2)(C) (West Supp. Pam. 1979); see S. REP.

ception in the new set-off provision and, in addition, expressed its desire to continue encouraging banks to assist faltering businesses.⁴⁰

It should be noted that, even in the absence of the "implied waiver" theory applied in *Dudley*,⁴¹ the set-off doctrine has several built-in limitations to prevent a bank from abusing its set-off privilege.⁴² For example, the courts have distinguished deposits in gen-

No. 95-989, *supra* note 38, at 87, U.S. CODE at 90, it is arguable that Congress intended to confine any new limitations imposed upon a bank's right to set-off to those embodied in § 553.

⁴⁰ See note 39 *supra*. Many courts and commentators have advanced the view that the set-off right should not be impaired. One noted commentator has stated that "the prevailing [set-off] doctrine is practical, [and] commercial good sense supports it." 4 W. COLLIER, *supra* note 1, ¶ 68.16, at 921-22; see 2 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 407 (rev. ed. 1940) (citing *Studley v. Boylston Nat'l Bank*, 229 U.S. 523 (1913)). In addition, § 68a has been described as "eminently just and increasingly favored in courts of bankruptcy, because of its essential fairness." *In re W. & A. Bacon Co.*, 261 F. 109, 111 (D. Mass. 1919).

⁴¹ See notes 27-29 and accompanying text *supra*.

⁴² Additionally, under narrowly defined circumstances, bank deposits may be deemed "transfers" voidable under the provision of the Bankruptcy Act addressing preferences. Bankruptcy Act § 60, 11 U.S.C. § 96 (1976). See, e.g., *Katz v. First Nat'l Bank*, 568 F.2d 968 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). Section 60, the general policing section, permits certain claims acquired by creditors against the bankrupt's estate to be voided as preferential transfers. The Act defines transfers to include "the sale and every other and different mode, direct or indirect, of disposing of or of parting with property, or with an interest therein." Bankruptcy Act § 1(30), 11 U.S.C. § 1(30) (1976). In *New York County Nat'l Bank v. Massey*, 192 U.S. 138 (1904), the Supreme Court held that general bank deposits do not constitute transfers. Since the statutory definition of "transfers of property . . . contemplate[s] the parting with the bankrupt's property for the benefit of the creditor and the consequent diminution of the bankrupt's estate," *id.* at 147, the *Massey* Court reasoned that a bank deposit, which does not deplete the depositor's estate, cannot be considered a "transfer." *Id.*; accord, *Studley v. Boylston Nat'l Bank*, 229 U.S. 523 (1913). Although *Massey* was decided under the Bankruptcy Act of 1898, its holding has been followed by courts construing the modern statutes. E.g., *Jensen v. State Bank*, 518 F.2d 1 (8th Cir. 1975); *Farmers Bank v. Julian*, 383 F.2d 314 (8th Cir.), *cert. denied*, 389 U.S. 1021 (1967); *Cusick v. Second Nat'l Bank*, 115 F.2d 150, 151-52 (D.C. Cir. 1940).

While § 60 does not generally affect a bank's right to set-off because of the requirement that there be a transfer, if the deposit is made with the intention that it be applied against an antecedent debt it will be considered a transfer within the meaning of the Act. Under such circumstances, the deposit may be deemed a voidable preference and thus unavailable for set-off. See, e.g., *Pirie v. Chicago Title & Trust Co.*, 182 U.S. 438, 446 (1901); *Katz v. First Nat'l Bank*, 568 F.2d 968, 971 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978). In *Katz*, the Second Circuit apparently expanded the scope of this rule by holding that a deposit intended by the depositor as payment on an antecedent debt may constitute a transfer even if the bank did not know of the depositor's intent. 568 F.2d at 971.

In addition to meeting the "transfer" requirement, however, a transaction must satisfy five other statutory prerequisites to constitute a voidable preference under § 60. In *Mayo v. Pioneer Bank & Trust Co.*, 270 F.2d 823 (5th Cir. 1959), the six elements of § 60a were described as follows:

- (1) [T]here must be a transfer of the debtor's property
- (2) to or for the benefit of a creditor
- (3) for or on account of an antecedent debt
- (4) the transfer must be made or suffered while the debtor is insolvent
- (5) within four months of bankruptcy

eral accounts from deposits placed in "special accounts."⁴³ Where deposits are dedicated to a special purpose that is known to the bank, the deposits may be deemed to be held in trust.⁴⁴ Under these circumstances, the requirement of "mutuality" of debts and credits⁴⁵ is not satisfied and the deposits are unavailable to the bank for set-off.⁴⁶ Additionally, the Bankruptcy Act itself limits the availability of the doctrine by disallowing the set-off of claims purchased or transferred subsequent to the filing of a petition in bankruptcy, or within 4 months thereof if the transaction was made "with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy."⁴⁷

It is suggested that the approach taken by the *Applied Logic* court is more desirable than that advanced by the Ninth Circuit in *Dudley*. In *Applied Logic*, the Second Circuit correctly suggested that notions of equitable distribution should be deemphasized in cases involving bank set-offs. Since the decision encourages banks to assist faltering businesses, it is consistent with the strong federal policy favoring rehabilitation rather than liquidation.

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and (6) the effect of the transfer must be to enable the creditor to obtain a greater percentage of his debt than another creditor of the same class.

Id. at 834-35 (emphasis added).

⁴³ *Union Bank & Trust Co. v. Loble*, 20 F.2d 124 (9th Cir.), *cert. denied*, 275 U.S. 545 (1927). Generally, there is a presumption that deposits are general rather than special. *See In re Cross*, 273 F. 29 (2d Cir. 1921); *White v. Pacific-Southwest Trust & Savs. Bank*, 9 F.2d 650, 658 (S.D. Cal. 1926), *rev'd on other grounds*, 15 F.2d 300 (9th Cir. 1926); 10 AM. JUR. 2d *Banks* § 363 (1963).

⁴⁴ *See, e.g., First Nat'l Bank v. Julian*, 383 F.2d 329 (8th Cir. 1967); *Union Bank & Trust Co. v. Loble*, 20 F.2d 124 (9th Cir.), *cert. denied*, 275 U.S. 545 (1927).

⁴⁵ *See note 1 supra*.

⁴⁶ *See* 4 W. COLLIER, *supra* note 1, ¶ 68.16, at 913.

⁴⁷ Bankruptcy Act § 68b, 11 U.S.C. § 108(b)(2) (1976); *see Western Tie & Timber Co. v. Brown*, 196 U.S. 502 (1905); *In re Merchandise Mart*, 79 F. Supp. 686 (E.D.S.C. 1948). A major distinction between preferences voidable under § 60a, 11 U.S.C. § 96(a)(1) (1976), and the invalidating of set-offs under § 68b, 11 U.S.C. § 108(b)(2) (1976), is that "intent" to acquire a preferential position is an element of the latter, but not the former. *See Katz v. First Nat'l Bank*, 568 F.2d 964, 970 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978); *Goldstein v. Franklin Square Nat'l Bank*, 107 F.2d 393 (2d Cir. 1939). One commentator has stated that "[t]he principal object of . . . § 68(b) is to prevent debtors of the bankrupt from acquiring claims against him for use by way of set-off and reduction of their indebtedness to the estate." 4 W. COLLIER, *supra* note 1, ¶ 68.12, at 903. The other limitations imposed by § 68b are discussed in note 1 *supra*. *See generally Continental & Commercial Savs. Bank v. Chicago Title & Trust Co.*, 229 U.S. 435 (1912).