View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by University of Kentucky

Kentucky Law Journal

Volume 34 | Issue 4 Article 6

1946

Rights and Duties of a Bank in the Application of a Deposit to the Payment of a Depositor's Obligation

Mary Garner Borden
University of Kentucky

Follow this and additional works at: https://uknowledge.uky.edu/klj

Part of the Banking and Finance Law Commons

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation

Borden, Mary Garner (1946) "Rights and Duties of a Bank in the Application of a Deposit to the Payment of a Depositor's Obligation," *Kentucky Law Journal*: Vol. 34 : Iss. 4 , Article 6.
Available at: https://uknowledge.uky.edu/klj/vol34/iss4/6

This Note is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledge@lsv.uky.edu.

STUDENT NOTES

RIGHTS AND DUTIES OF A BANK IN THE APPLICATION OF A DEPOSIT TO THE PAYMENT OF A DEPOSITOR'S OBLIGATION

It has become customary in present day business transactions for a bank to be the primary collection agency for notes and other obligations. In some cases the bank has legal and beneficial interest in the obligation. In other cases the bank merely holds the obligation for collection or as pledgee. It is a common practice for a bank to collect such an indebtedness from one of its depositors by the simple expedient of deducting from his deposit a sum sufficient to pay the debt. It is the purpose of this note to discuss the various situations in which a bank has a *right* to so apply a deposit, and also to consider those cases in which a bank owes a *duty* to a depositor or a surety on an obligation to apply a deposit to the payment of the obligation.

Let us consider first the rights of a bank to so apply a deposit. It is provided in Section 87 of the Negotiable Instruments Law that: "Where the instrument is made payable at a bank it is equivalent to an order to the bank to pay the same for the account of the principal debtor thereon." This undoubtedly gives a bank the right to pay out a deposit in satisfaction of an obligation of the depositor which is payable at the bank. However, when the instrument is not expressly made payable at the bank, but the bank has legal and beneficial interest in it, the bank has the right to apply the maker's deposit to the payment of the obligation.[1] This right is based on the principal of set-off of mutual debts. Clearly, when a bank is indebted to a depositor for the amount of his deposit and the depositor is indebted to the bank for the amount of his obligation, these are mutual debts and one may be set off against the other. There is no such mutuality, however, in the case of obligations which the bank does not own but merely holds for collection or as pledgee; unless the obligation is expressly made payable at the bank, the bank has no right to apply the maker's deposit in payment of the obligation.[2] In the case of an obligation which is not yet due, there is no mutuality unless the maker has become insolvent.[3] In such a situation the courts

[1] National Mahaiwe Bank v. Peck, 127 Mass. 298 (1878); Menkes Feuer, Inc. v. People's Bank of Johnstown, 43 N. Y. S. 2d 32 (1944).

[2] Clearwater County et al. v. Pfeffer, 236 Fed. 183 (1916); Stetson v. Exchange Bank, 73 Mass. (7 Gray) 425 (1856); Trible v. Bank of Grenada, 6 Miss. (2 Smedes & M.) 523 (1844).

[3] Clearwater County et al. v. Pfeffer, 236 Fed. 183 (1916); Ky. Flour Co's Assignee v. Merchants' Nat. Bank, 90 Ky. 225, 13 S. W. 910 (1890). *Contra:* Harding v. Broadway Nat. Bank of Chelsea, 294 Mass. 13, 200 N. E. 386 (1936).

consider that the insolvency of the maker causes the obligation to become immediately due. It is not necessary that the maker actually be declared insolvent by a court proceeding, but if the bank can prove him insolvent in fact at the time the set-off is made, the bank has the right to apply his deposit as a set-off against the obligation.[4] This is not considered a preference of the bank over other creditors of the insolvent maker, as the equity of the bank in the deposit is considered superior in time and in merit to that of the general creditors.[5] Only by allowing the debts to be set off can they be treated as being on an even basis.

Generally, there is no right to apply a deposit belonging to someone other than the debtor to the payment of the debt.[6] A bank cannot apply the deposit of a partnership to the payment of a debt owed by one of the individual partners.[7] Nor does it generally have the right to apply the deposit of a member of a partnership to the indebtedness of the partnership.[8] However, the individual partners are jointly and severally liable on an obligation of the partnership, and by Section 27 of the Kentucky Civil Code, a creditor of the firm has the right to sue and levy execution against any one, or all of the partners, at his option. For these reasons, the Kentucky Court has held that the deposit of one of the partners can be set off against an obligation of the partnership.[9] Presumably this rule would be followed in other jurisdictions having a code provision similar to that of Kentucky.

Similarly, a bank has no right to apply a deposit made in trust for someone other than the depositor,[10] nor a deposit designated to some particular use,[11] if the bank has notice of this fact. This notice is essential, however, or the bank has the right to apply such a deposit.[12]

---

[4] Thomas v. Nat. Bank of New Jersey, 16 N. J. Misc. 271, 198 Atl. 539 (1938).

[5] *Id.*

[6] Bryant v. Williams, 16 F. 2d 159 (1926); Wescott v. People's State Bank of Reeseville, 206 Wis. 105, 238 N. W. 803 (1931).

[7] Hulse v. Knapp, 20 F. Supp. 137 (1937); First State Bank of Denton v. Vestal and Naugle, 48 S. W. 2d 706 (Tex. 1932).

[8] Hulse v. Knapp, 20 F. Supp. 137 (1937); Teeters v. City Nat. Bank of Auburn, 214 Ind. 498, 14 N. E. 2d 1004 (1938); Elliott et al. v. Flynn Bros., 184 S. C. 391, 192 S. E. 400 (1937).

[9] Owsley v. Bank of Cumberland, 23 Ky. L. Rep. 1726, 66 S. W. 33 (1902).

[10] First Nat. Bank of Owenton v. Greene, 114 S. W. 322 (Ky. 1908); Menkes Feuer, Inc. v. People's Bank of Johnstown, 43 N. Y. S. 2d 32 (1944); Western Shoe Co. v. Amarillo Nat. Bank, 42 S. W. 2d 469 (Tex. 1931).

[11] Twentieth Street Bank v. Gilmore, 71 F. 2d 594 (1934); Royse v. Winchester Bank, 148 Ky. 368, 146 S. W. 738 (1912); Hadley v. Passaic Nat. Bank and Trust Co., 113 N. J. Eq. 548, 168 Atl. 38 (1933); First Nat. Bank of Schulenburg v. Winkler, 146 S. W. 2d 201 (Tex. 1940).

[12] White v. Pacific Southwest Trust and Savings Bank, 9 F. 2d 650 (1926).

Let us now consider the duties of a bank to apply a deposit in payment of a depositor's obligation. In those cases in which a bank has no right to apply a deposit, it of course has no duty to make such application. But when a bank has a right to apply a deposit there are, in addition, some situations in which there is a corresponding duty, to the maker or to a surety or indorser on the instrument, to apply the maker's deposit to the payment of the obligation.

There is only one instance in which a bank owes a duty to the maker of the obligation. If the bank becomes insolvent, the depositor has a right to insist on the application of his deposit to the payment of an obligation held by the bank and on which he is primarily liable.[13] This right of the depositor, which gives rise to a corresponding duty on the part of the bank, is based on the same equities which give the bank the right of set-off when the depositor-maker becomes insolvent.

It is often insisted that a bank owes a duty to a surety or indorser on a note or other instrument to apply the maker's deposit to the payment of the instrument, and that the failure of the bank to so apply will discharge the surety. But the general rule is that the bank is under no duty in such a situation, and the surety or indorser will not be discharged by the bank's failure to apply the deposit.[14] It has been held in some states that there is a duty to apply a deposit *existing at the time* the note matures,[15] and in one jurisdiction it is held that there is a duty to apply a deposit made *subsequent* to maturity.[16]

The Kentucky Court makes a clear distinction between a deposit existing at the time the note matures, and a deposit made subsequent to its maturity. In the first situation, there is such a duty to apply that the failure of the bank will discharge the obligation of a surety.[17] In the second situation the bank has the right to set off the deposit but is held to no duty to do so.[18] This latter rule was adopted as recently as 1930 when, in the case of *Farmer's Na-*

[13] Scott v. Armstrong, 146 U. S. 499 (1892); Rossi Bros. v. Commissioner of Banks in Possession of Highland Trust Co., 283 Mass. 114, 186 N. E. 234 (1933).

[14] Davenport v. State Banking Co., 126 Ga. 136, 54 S. E. 977 (1906); Second National Bank of Lafayette v. Hill, 76 Ind. App. 225, 40 Am. Rep. 239 (1881); Nat. Mahaiwe Bank v. Peck, 127 Mass. 298 (1898); ARANT, SURETYSHIP (1931) Sec. 65; Note (1916) 29 HARV. L. REV. 231.

[15] Tatum v. Commercial Bank and Trust Co., 193 Ala. 120, 69 So. 508 (1915); Franklin Savings and Trust Co. of Pittsburg v. Clark, 283 Pa. 212, 129 Atl. 56 (1925).

[16] McDowell v. Bank of Wilmington and Brandywine, 1 Harr. 369 (Del. 1834).

[17] Pursifull v. Pineville Banking Company's Assignee, 97 Ky. 154, 30 S. W. 203 (1885).

[18] Farmer's Nat. Bank v. Jones, 234 Ky. 591, 28 S. W. 2d 787 (1930).

tional Bank v. Jones,[19] the court specifically overruled previous decisions which had imposed a duty on the bank to apply deposits made subsequent to maturity.

It would seem that the better rule would be to hold that the bank has no duty to an indorser or surety on a note to apply deposits made either at or after its maturity. The relation of a bank to its depositor is merely that of debtor-creditor. The bank has no lien on the deposit for payment of the note, as the bank has actual title to the money which the maker of the note has deposited, and the bank certainly has no express nor implied agreement to hold the deposit as collateral for the note, nor in trust for the surety. The fact that the creditor bank is named as the place of payment of the note may act as a direction to apply the deposit to the payment of the note at maturity, but this should not impose any obligation on the bank, nor preclude the right of the depositor to draw on his account whenever he desires. The contract formed by the deposit is independent of the contract on the note. It would seem to be an unwarranted obstruction to commercial transactions to impose upon the bank the duty of withholding payment of every check until it is definitely ascertained that the depositor has no note owing the bank which has come due on that banking day or previously.

The foregoing review of the cases applicable to the rights and duties of a bank in making a set-off of a deposit against an obligation of the depositor leads to the conclusions which follow. Only when there is mutuality between the two debts does a bank have a *right* to set off one against the other. When other factors enter to complicate the situation and destroy the mutuality, the bank can usually make no such application of the deposit. Generally it may be said that a bank has no *duty* to apply a deposit to the payment of an obligation of the depositor, except in one instance. When the bank itself has become insolvent, it owes a duty to the depositor.

The fact cannot be disputed that it is advisable for the bank to be able to protect itself, as far as possible, as the holder of a note of one of its depositors. But due to the growing complexity of commercial transactions and the increasing volume of business done by modern banks in both the checking and the loan departments, it would seem advisable to separate the two functions of the bank completely, and to consider the depositor who is creditor of the bank for the amount of his deposit, and the maker of a note who is a debtor of the bank for the amount of his note, as two separate and distinct persons, for this purpose.

MARY GARNER BORDEN

[19] *Id.*