Use It or Lose It? Priority Disputes over Deposit Accounts

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Recent cases reaching starkly contradictory conclusions have intensified the battle between a Uniform Commercial Code (UCC) secured creditor with a perfected security interest in a deposit account (hereinafter, "UCC creditor") and a garnishing unsecured judgment creditor (hereinafter, "garnishing creditor"). The cases are difficult to reconcile. Cases from Illinois and Florida give the victory to the garnishing creditor unless the UCC creditor has declared a default and is exercising its rights, while Nebraska, Michigan and Indiana cases favor the UCC creditor, even if that creditor is forbearing and permits the debtor to use the funds. How can these cases reach such different results?

UCC Article 9 Structure as to Deposit Accounts

Underlying this battle is fundamental commercial financing law under the UCC, in particular perfection and priority of security interests in deposit accounts. Revised UCC Article 9, which became effective July 1, 2001, includes deposit accounts as original collateral in which a security interest can be taken, except in consumer transactions.[1]

Perfection in deposit accounts is only accomplished by control.[2] The "control" of deposit accounts occurs (1) if the secured party is the depository bank; (2) by a three-party control agreement among the secured party, depository bank and debtor requiring the bank to comply with instructions of the secured party without further consent from the debtor; or (3) if the secured party actually becomes the bank's customer as to the deposit account.[3] Perfection by control occurs even if the debtor has the right to make withdrawals from the account, and even if the control agreement requires that secured party to certify that a default occurred before it can seize the funds.[4]

A garnishment served on a depository bank typically gives rise to a judicial lien, but a security interest perfected in a deposit account before a person becomes a lien creditor has statutory priority over the lien creditor.[5] A security interest in a deposit account is a property interest, which is distinct from a mere procedural right of setoff.[6] The bank may also have a right of setoff (UCC § 9-340), but at least one observer has indicated that it was anticipated that the holder of a security interest would have greater rights against other creditors as contrasted with a setoff right.[7]

Cases Favoring Garnishment Creditors

American Home Assurance Co. v. Weaver Aggregate Transport Inc.

In *American Home Assurance Co. v. Weaver Aggregate Transport Inc.*,[8] loans secured *inter alia* by the borrower's deposit account were not in default until a writ of garnishment was served on the UCC creditor (which was also the depository bank) by the garnishing creditor.[9] In response, the UCC creditor asserted its perfected security interest in the deposit account, confirmed that it had declared the loans in default, and claimed a right to apply the funds.[10]

The garnishing creditor obtained deposition testimony from the UCC creditor's senior vice president that the UCC creditor neither knew of the underlying judgment (entered prior to the loans being made) nor declared the loans to be in default until after the service of the garnishment writ.[11] The garnishing creditor then challenged the UCC creditor's right to set off the funds and argued that based on the testimony and notwithstanding the UCC creditor's perfected security interest, the UCC creditor was not entitled to the funds because it did not declare the loan to be in default until after service of the garnishment writ.[12]

The "key question" framed by the court was "whether the [loans were] in default at the time the writ was served."[13] The court answered in the negative, rejecting the bank's arguments and the senior vice president's testimony that the service of the writ "made it feel insecure" and that performance under the loans was therefore "impaired" in both events of default.[14] The court was unpersuaded by the argument that service of the writ itself was a default, noting the distinction drawn by the senior vice president between a payment default — which was "self-executing," did not require a formal declaration of a default and had not occurred at the time of service of the writ — and a non-monetary default (like insecurity) that required the bank to affirmatively decide whether there was a default.[15] The court concluded that the law and security agreement established default as "the essential prerequisite" to the UCC creditor's ability to seize the deposit account funds. The absence of a default meant that the UCC creditor could not set off the deposit account funds to stop the garnishing creditor from taking the funds.[16]

American Home was decided under Illinois law (the loan documents contained Illinois choice-of-law provisions), but also discussed Florida law, which the court thought favored the garnishment creditor.[17] The court's use of "setoff" terminology was confusing and may explain part of its conclusion.[18]

Other "Use It or Lose It" Cases

This "use-it-or-lose-it" approach adopted by the Florida district court under Illinois law was based in part on *One CW LLC v. Cartridge World North America LLC*[19] and *S.E.I.U. Local No. 4 Pension Fund v. Pinnacle Health Care of Berwyn LLC*.[20] In *One CW*, the U.S. District Court for the Northern District of Illinois ruled in favor of the garnishment creditor and against the UCC creditor (also the depository bank).[21] Like *American Home*, *One CW* focused on the language of the subject security agreement, which the court interpreted to only afford the UCC creditor the rights of a secured party under the UCC *upon default*.[22] Also, the UCC creditor's decision to let the debtor continue to access the funds in the deposit account after the service of a citation (which created a judgment lien to the benefit of the judgment holder) was viewed as a waiver of the UCC creditor's prior right to the account.[23]

American Home, *S.E.I.U.*, and *One CW* rely on a pre-revised UCC Article 9 case out of the Eighth Circuit called *Frierson v. United Farm Agency Inc.*[24] The *Frierson* holding was similar: The UCC creditor could not "refuse to exercise its rights . . . while it impairs the status of other creditors by preventing them from exercising valid liens."[25] However, *Frierson* was decided well before Revised UCC Article 9 and its establishment of deposit accounts as original collateral, discussed *supra*.

Cases Favoring Perfected Secured Creditors

Myers v. Christiansen

Six years prior to *American Home*, the Supreme Court of Nebraska rejected the waiver concept and protected the UCC creditor's prior perfected security interest in the deposit account in *Myers v. Christensen*.[26] In *Myers*, the garnishing creditor sought to hold the UCC creditor liable for all amounts owed to it by the debtor because the UCC creditor continued to honor checks that were written against the debtor's account after receipt of the garnishment, even though the loans secured by the account were in default prior to the service of the garnishment summons.[27]

The lower court ruled in favor of the garnishing creditor on the basis that the UCC creditor's failure to hold the deposit account funds violated the garnishment statute and constituted a waiver of the UCC creditor's right to the funds.[28] The court pondered whether the judgment debtor had any right to the deposit account that was superior to that of the UCC creditor (again, the depository bank) as of the service of the garnishment, and further, whether the non-exercise of the UCC creditor's right until after service of the garnishment operated to extinguish or subordinate that right.[29] The court answered those questions in the negative based on Revised UCC Article 9's priority structure, reasoning that the UCC creditor's prior perfected security interest trumped the debtor's (and therefore, its garnishing creditor's) right to the account funds.[30] The court reasoned that the principles that might have applied prior to Revised UCC Article 9 "would ignore and indeed negate the statutory priority to which a holder of a perfected security interest is entitled."[31] Due to this statutory priority, the concept of waiver did not apply.[32]

Fifth Third Bank v. Peoples National Bank

In *Fifth Third Bank v. Peoples National Bank*,[33] the trial court ordered the UCC creditor (Fifth Third) to turn over the garnishment funds to the garnishing creditor (Peoples National Bank or "PNB"). Fifth Third appealed based on its UCC priority, and PNB argued waiver, in part because Fifth Third had continued to honor the debtor's checks.[34] Relying on Fifth Third's UCC priority in reversing the trial court, the court rejected the argument that Fifth Third lost its priority by failing to exercise its right to seize and apply the funds, stating that "[a] garnishing creditor has no greater rights in the judgment debtor's assets than does the judgment debtor."[35]

The court described this as the "majority view" and cited to UCC § 9-104(b) for the proposition that a UCC creditor's latitude to allow its indebted depositors access to funds is not inconsistent with perfection and priority in a deposit account and did not result in any waiver.[36] It concluded that since

> the funds in [the debtor's] deposit account were under the control of Fifth Third, and were considerably less than the indebtedness owed to Fifth Third, Fifth Third's rights therein were superior to those of PNB . . . thus, the deposit account was not subject to attachment to satisfy the PNB judgment.[37]

Miracle Feeds v. Attica Dairy Farm* and *System Soft Technologies v. Artemis Technologies

An older but instructive pre-Revised UCC Article 9 case dealing with a security interest in milk sale proceeds, *Miracle Feeds Inc. v. Attica Dairy Farm*,[38] held that a garnishing creditor was defeated even though the UCC creditor was not taking all of the collateral proceeds. In *Miracle Feeds*, an informal out-of-court creditor arrangement did not include the garnishing creditor.[39] The court ruled in large part on (pre-revised) UCC 9-205, which is similar to Revised UCC 9-205.[40] This was a major policy change to original UCC Article 9, repealing the "police your collateral" perfection rule of *Benedict v. Ratner*,[41] and enabling the "floating lien" of modern commercial finance.[42] The court stated:

The bank's rights in relation to others claiming an interest in the collateral are not determined by the debtor's default . . . . Rather . . . [they] depend upon the bank's compliance with the provisions of [UCC Article 9] governing the perfection and priority of security interests."[43]

Similarly, in *System Soft Technologies LLC v. Artemis Technologies Inc.*,[44] a garnishment was served on account debtors who owed receivables to the debtor. The UCC creditor and debtor entered into a forbearance agreement whereby the debtor continued to use funds from the deposit account to pay expenses.[45] The UCC creditor argued that the only way that unsecured creditors might be paid would be if the debtor stayed in business.[46] The trial court quashed the garnishment based on the UCC creditor's prior perfected security interest, rejecting the argument that the UCC creditor had to enforce its security interest in order to enjoy its priority.[47] The court also noted that the UCC does not require the UCC creditor to foreclose on its collateral.[48]

Conclusion

Who should win the battle? It is undisputed in the discussed cases that the UCC creditor was perfected and had priority, but should that priority trump the garnishing creditor, even if the debtor is not in default or the UCC creditor is forbearing? If the UCC creditor's "prior" security interest in the deposit account is not protected, what then does "priority" mean? It seems especially harsh to lose collateral when the garnishment creates the default.

It can be argued that state legislatures made a policy choice favoring the UCC creditor in decreeing that control priority is accomplished even though debtors can use the deposit account until the UCC creditor says they cannot. Prior to Revised UCC Article 9, common law perfection of security interests in deposit accounts normally required "blocked" or complete control. Lawmakers went the opposite way with Revised UCC Article 9.

The effect of allowing a garnishing creditor to defeat a prior perfected UCC creditor should also be examined. Pursuant to UCC § 9-610, disposition of collateral such as equipment by a junior creditor does not cut off or violate a senior creditor's security interest[49] because the senior secured party can take the collateral from the buyer and dispose of it. However, allowing a garnishing creditor to seize account funds notwithstanding a prior UCC Article 9 security interest would cut off the senior UCC creditor's rights pursuant to UCC § 9-332 (a transferee of funds out of a deposit account takes free of a prior security interest unless there is collusion).[50] Cases that discuss a secured creditor's right, notwithstanding garnishment, to retrieve the funds from the garnishing creditor later (perhaps in a conversion lawsuit) neglect the effect of UCC § 9-332.

A particular state's garnishment law may affect the outcome of this battle and be a cause of nonuniformity across the states. However, the UCC uniformity policy should carry some weight, and it is noteworthy that none of the "use it or lose it" cases actually hinge on garnishment law. Finally, while this may seem to be just a battle between creditors, the debtor is very interested and could well be on the side of the UCC secured creditor and wanting to stave off other unsecured creditors while attempting to avoid an insolvency proceeding.

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[1] *See* U.C.C. §§ 9-109(a), 9-109(d)(13) and 9-109 Official Comment 16.

[2] *See* U.C.C. §§ 9-312(b)(1) and 9-314(a). Filing alone does not accomplish perfection in deposit accounts as original collateral, but filing might be sufficient for perfection if the funds in the account are proceeds of other collateral. *See* U.C.C. § 9-315(c)–(e).

[3] *See* U.C.C. § 9-104(a).

[4] *See* U.C.C. § 9-104(b) and Official Comment 3.

[5] *See* U.C.C. § 9-317(a)(2).

[6] *See generally* Bruce A. Markell, "From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9," 74 Chic. Kent L. Rev. 963, 969, 1006, 1026 (1999).

[7] *Id*. at 1026.

[8] 84 F. Supp. 3d 1314 (M.D. Fla. 2015).

[9] *Id*. at 1318.

[10] *Id*.

[11] *Id*. at 1318, 1320.

[12] *Id*. at 1318.

[13] *Id*. at 1320.

[14] *Id*. at 1321–22.

[15] *Id*.

[16] *Id*. at 1325–26.

[17] *Id*. at 1319.

[18] There is much law not discussed in this article regarding the bank's right of setoff vs. the garnishment creditor. Generally, to be entitled to setoff under common law, the debts must be mutual, which requires that they both be due. Revised UCC Article 9 recognizes that setoff is different from a security interest and preserves that setoff right. *See* U.C.C. § 9-340.

[19] 661 F. Supp. 2d 931 (N.D. Ill. 2009).

[20] 560 F. Supp. 2d 647 (N.D. Ill. 2008).

[21] *One CW*, 661 F. Supp. 2d at 936–37.

[22] *Id*. at 934–35 (emphasis added).

[23] *Id*. at 935.

[24] 868 F.2d 302 (8th Cir. 1989).

[25] *Id*. at 305.

[26] 776 N.W.2d 201 (Neb. 2009).

[27] *Id*. at 203–05.

[28] *Id*. at 204.

[29] *Id*. at 205–06.

[30] *Id*.

[31] *Id*. at 207.

[32] *Id*. at 205–07.

[33] 929 N.E.2d 210 (Ind. Ct. App. 2010).

[34] *Id*. at 213–14.

[35] *Id*. at 216.

[36] *Id*. at 214–16.

[37] *Id*. at 217.

[38] 385 N.W.2d 208 (Wis. 1986).

[39] *Id*. at 209.

[40] *Id*. at 210. ("[A] security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use . . . collateral . . . or to collect . . . accounts.")

[41] 268 U.S. 353 (1925).

[42] *Miracle Feeds*, 385 N.W.2d at 210–12.

[43] *Id*. at 211; *see also* 79 *C.J.S. Secured Transactions* § 104, which references *Miracle Feeds* and states that "[a] secured creditor is under no obligation to act in the best interest of all other creditors."

[44] 837 N.W.2d 449 (Mich. Ct. App. 2013).

[45] *Id*. at 450.
[46] *Id*. at 452.
[47] *Id*. at 451–52.
[48] *Id*. at 455.
[49] *See* U.C.C. § 9-610, Official Comment 5.
[50] *See Orix Fin. Servs. Inc. v. Kovacs*, 83 Cal. Rptr. 3d 900 (Cal. Ct. App. 2008), as modified (October 16, 2008).
