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Bank Credit Cards and the Right of Setoff

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NOTES

BANK CREDIT CARDS AND THE RIGHT OF SETOFF

I. INTRODUCTION

Credit card systems have existed in this country since the turn of the century[1] but until 1950 were utilized only by retail merchants and service organizations as a convenience for their customers.[2] In that year the Diner's Club, Inc., became the first independent company to issue general purpose credit cards, followed in the late 1950's by The American Express Company and the Hilton Credit Corporation (Carte Blanche Card).[3] The late 1950's also marked the entry of major banks into competition for the credit card market with a third distinct type of credit card system.[4] This article focuses upon bank credit cards and a charac-

1. Credit cards were preceded by credit coins, which were used primarily by department stores in the early 1900's. These were small metal discs stamped with the merchant's name and the customer's account number. *See* Davenport, *Bank Credit Cards and the Uniform Commercial Code*, 1 VAL. U.L. REV. 218 (1967), *reprinted in* 85 BANK. L.J. 941 (1968) [hereinafter cited only to BANK. L.J.]; Comment, *Implied Contract—Credit Coins and Cards—Negotiability*, 2 U. PITT. L. REV. 117 (1936).

2. The first credit cards were issued by nation-wide oil companies about 1914. Local department stores adopted the idea, and airlines and railroads later followed suit. Davenport, *supra* note 1, at 942.

3. *Id.* at 942-43; Comment, *Bank Credit Cards—Contemporary Problems*, 41 FORD. L. REV. 373 (1972). Primarily used by businessmen, these three cards dominated the independent credit card field until the entry of the major banks. They became known as the "T & E cards" (travel and entertainment). *Id.* at 373 n.4.

The fundamental innovation of these independent credit cards was the introduction of a third party into the system—a party engaged in extending credit without selling merchandise. This third party would enlist a nation-wide system of merchants to make credit sales to the cardholders, thus greatly increasing the flexibility of the cards and the convenience to consumers. The third party enters two distinct contracts. First, there is a contract with the cardholder, in which the third party agrees to extend credit to the cardholder by paying for items obtained through use of the card, while the cardholder agrees to repay these credit advances on specified items. Second, there is a contract with each participating merchant, in which the merchant agrees to honor the credit card by making sales and recording them on the proper forms, while the third party agrees to pay the merchant for the items or services purchased. *See generally* Weistart, *Consumer Protection in the Credit Card Industry: Federal Legislative Controls*, 70 MICH. L. REV. 1476, 1476-77 (1972).

4. Weistart, *supra* note 3, at 1477. The bank credit card system involves essentially the same three-party structure as do the older independent systems. *See* note 3 *supra*. Nevertheless, bank cards warrant recognition as a distinct class of credit system, both

teristic peculiar to them: the potential for collecting a cardholder's delinquent credit card debt by setting it off against a savings or checking account maintained by the cardholder with the issuing bank.

Until recently setoff has not been among the credit card practices challenged by consumer protection advocates. Instead, their efforts have been directed at securing corrective legislation in such areas as waiver-of-defense clauses,[5] unsolicited mailings,[6] and cardholders' liability for unauthorized use.[7] The interest in setoff, however, is no longer dormant, for bills have been introduced in both the Ninety-Second[8] and Ninety-Third[9] Congresses that would virtually eliminate the practice. Critics of setoff are particularly upset because the consumer is seldom aware that his bank possesses the right until it has been exercised against him.[10] Moreover, collecting credit card debts by setting them off is apparently not uncommon.[11] The following statement by Professor William F. Willier, Director of the National Consumer Law Center at Boston College Law School, crystallizes the argument against setoff:

> In almost every jurisdiction, banks have long enjoyed the right to unilaterally set-off their alleged claims of indebtedness

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because of the unique nature of a banking institution as the third party and because bank cards are oriented primarily toward consumers rather than businessmen. This consumer orientation is manifested in many ways, including the relative ease of acquiring bank cards, the number and type of organizations honoring them, and the emphasis on revolving or installment bases for payment. *See generally* Davenport, *supra* note 1, at 943.

Many bank credit card transactions actually involve four parties rather than three because there is both an "issuing bank" dealing with the cardholder and a "depository bank" dealing with the merchant. The mechanics of a bank card system and the clearance arrangement among banks are described in detail in Davenport, *supra* note 1, at 950-61. For the purposes of this article, the differences between the three-party and four-party models are immaterial.

5. *See* note 35 *infra.*

6. Truth in Lending Act § 132, 15 U.S.C. § 1642 (1970); *see* Weistart, *supra* note 3, at 1485-1508.

7. Truth in Lending Act § 133, 15 U.S.C. § 1643 (1970); *see* Weistart, *supra* note 3, at 1508-43.

8. S. 652, 92d Cong., 1st Sess. (1971).

9. S. 2101, 93d Cong., 1st Sess. (1973).

10. *Hearings on S. 652 Before the Subcomm. on Fin. Institutions of the Senate Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 1st Sess. 288 (1971) (statement of Betty Furness). The Master Charge agreement examined by the authors describes the issuing bank's right of setoff, but the BankAmericard agreement does not. *See* note 32 *infra.*

11. S. REP. No. 93-278, 93d Cong., 1st Sess. 9 (1973); *Hearings on S. 652, supra* note 10, at 236 *passim.*

against deposit accounts. Reported appellate decisions reveal that the practice originally arose and has been continued in the context of business transactions. The advent of the bank credit card, however, has occasioned extensive use of the set-off against consumers.

The Center has received numerous complaints of this practice from lawyers throughout the country. In every instance, the account being set-off against consisted of the family checking account which represented the wages of the head of the family and was being relied upon for the procurement of necessary goods and services.

. . . [B]anks have apparently attempted to recoup losses occasioned by their reckless and improvident merchandising by appropriating the checking accounts of unwary consumers, extending them no opportunity to defend themselves of [*sic*] work out an alternative system for payment.[12]

Despite the numerous complaints received by the National Consumer Law Center, only a few cases challenging credit card setoff have been filed,[13] and to date no judicial decisions have been reported. Consumer concern about setoff may become acute, however, because the incidence of setoff is likely to increase as outstanding cards proliferate. Currently more than one of every six American families uses a bank card regularly,[14] and many of these families are by no means affluent.[15] Notwithstanding this

12. *Hearings on S. 652, supra* note 10, at 236-37.

13. Jojola v. Wells Fargo Bank, Civil No. C-71,900 (N.D. Cal., filed May 12, 1971); Gleason v. Newton-Walton Bank & Trust Co., Civil No. 70-1291M (D. Mass. 1970). The latter suit was filed and then dismissed after the parties agreed to settle. Telephone interview with John H. Higgs, attorney for plaintiff, of N.Y. City, Nov. 3, 1972.

14. A study by the Institute for Social Research at the University of Michigan estimated that of the 70 million families in the United States 12 million now use bank credit cards—or approximately one-sixth of all families. S. REP. No. 93-278, 93d Cong., 1st Sess. 4 (1973). This estimate is conservative in comparison with a statement by the National Commission on Consumer Finance indicating that the two leading bank credit card systems alone serve an estimated 62 million consumers, which surely represents more than 12 million families. NATIONAL COMM'N ON CONSUMER FINANCE, CONSUMER CREDIT IN THE UNITED STATES 204 (Proof Copy, Dec. 1972) [hereinafter cited as CONSUMER FIN. REP.].

15. A characteristic of bank credit cards is that their use is not restricted to those who have secure sources of income and the financial stability to pay their credit card bills even when unexpected expenses occur. For example, a survey by the American Bankers Association is reported to have made the following findings: "Some 3,033 households were surveyed in a sample survey. Of these, 913 had bank credit cards, or just under 1 in 3. Only about 47% of the cardholders had some college education, and about 20% had never graduated from high school. Analyzed by income level, about 42% had incomes of under $10,000." *Hearings on S. 652, supra* note 10, at 259 (statement of Fairfax Leary, Jr., Public Interest Research Group).

popularity, banks continue to sustain heavy losses from credit card operations,[16] and it is therefore reasonable to assume that they will resort to setoff with greater frequency. These conditions will no doubt awaken the zeal of consumer protection advocates, especially as some of the higher priority consumer issues are resolved.

In short, unless remedial legislation intervenes, the legality of setting off credit card debts will soon be tested in the courts. The purpose of this article is to examine the cogency of three arguments that might bring about the judicial limitation of setoff: (1) that the mechanics of credit card setoff do not conform to those required by common law doctrine; (2) that setoff violates the due process clause of the fourteenth amendment; and (3) that setoff is subject to regulation under existing consumer protection statutes. In addition, a proposed legislative response to the question of credit card setoff is evaluated.

II. COMMON LAW REQUISITES FOR SETOFF

By setting off cardholders' debts against their deposit accounts, the banking community is simply seeking to bring a modern fact situation within the traditional rule that a bank may apply a customer's deposits to satisfy a matured debt owed by him to the bank.[17] Setoff is a right based on equitable principles arising from the debtor-creditor relationship between a bank and its depositor.[18] Unless the parties' contract provides otherwise,[19] a bank may set off against a customer's account without initiat-

16. Total losses were at least $115 million in 1970, more than 50% higher than in 1969, according to Federal Reserve Board statistics. *Hearings on S. 652, supra* note 10, at 167 (statement of Walter D. Malcolm). This figure represented some 1.8% of the systems' year-end outstandings. CONSUMER FIN. REP., *supra* note 14, at 204. The assumption is that banks continue to accept these heavy losses because they envision bank credit cards as the forerunner of an "electronic funds transfer system," with the credit card losses being essentially research and development costs. *Id.* Perhaps banks also use a credit card system as a "loss leader," that is, a promotional device to attract customers who will utilize the banks' more remunerative services.

17. United States v. Butterworth-Judson Corp., 267 U.S. 387, 395 (1925) (dicta); Fidelity & Deposit Co. v. Scott Bros. Constr. Co., 461 F.2d 640 (5th Cir. 1972); Holloway v. First Nat'l Bank, 45 Idaho 746, 265 P. 699 (1928); Goeman v. Live Stock Nat'l Bank, 238 Iowa 1088, 29 N.W.2d 528 (1947); Kasparek v. Liberty Nat'l Bank, 170 Okla. 207, 39 P.2d 127 (1934).

18. *See* Moore v. Greenville Banking & Trust Co., 173 N.C. 180, 91 S.E. 793 (1917); Jeter v. Citizens Nat'l Bank, 419 S.W.2d 916 (Tex. Civ. App. 1967).

19. *E.g.*, Mohan v. Woburn Nat'l Bank, 313 Mass. 306, 47 N.E.2d 289 (1943); Livingstain v. Columbian Banking & Trust Co., 77 S.C. 305, 57 S.E. 182 (1907). When a customer

ing a judicial proceeding,[20] giving notice to the customer,[21] or securing his consent.[22] The utility of such an unrestricted power is readily apparent for, with a simple bookkeeping operation,

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deposits funds in a general deposit account, title to the funds passes to the bank which then becomes indebted to its customer for the amount deposited. 5A A. MICHIE, BANKS AND BANKING § 1 (1950) [hereinafter cited as MICHIE].

20. Gonsalves v. Bank of America Nat'l Trust & Sav. Ass'n, 16 Cal. 2d 169, 105 P.2d 118 (1940).

21. Delano v. Equitable Trust Co., 110 Misc. 704, 181 N.Y.S. 852 (Sup. Ct. 1920).

In 5A MICHIE § 115d, the following statement is made: "In South Carolina a bank cannot apply a depositor's balance to the payment of his indebtedness to it without his consent or previous notice to him." Although this assertion is marginally supported by the two cases cited as authority, and there has been no direct holding to the contrary by the South Carolina Supreme Court, it is extremely doubtful that this is a correct statement of the law in South Carolina today.

The first cited case is Simmons Hardware Co. v. Bank of Greenwood, 41 S.C. 177, 19 S.E. 502 (1894). The corporate depositor had maintained two separate accounts and had treated them consistently as segregated accounts for some time; one of them frequently showed a deficit because of the company's financial arrangement with the bank. The court ruled that the bank could not claim a setoff from the other account on the occasion in question. The decision appears to be based upon alternative holdings: (1) There was an implied contract that the two accounts would be kept separate in their application, so that the bank could not set them off without the *consent* of the company (*see* note 22 and accompanying text *infra*); (2) the long-standing custom between the parties estopped the bank from changing its practice without *notice* to the company. This is probably the language upon which MICHIE relied, but it clearly does not support the broad statement made therein.

The second cited case is Callahan v. Bank of Anderson, 69 S.C. 374, 48 S.E. 293 (1904). In *Callahan* the controlling opinion definitely held that bank setoff could not take place without either notice or consent. (It is not clear exactly which would be required.) The opinion treats *Simmons Hardware* as mandatory authority, perhaps because counsel for the bank gave notice that he wished to argue for its reversal. The court was split 2-2 on the case, however, with the result that the lower court decision was allowed to stand—hardly a persuasive precedent. The dissent, demonstrating that *Simmons Hardware* was not in point, is the more impressive opinion.

Shortly thereafter, the court was faced with a fact situation very similar to *Simmons Hardware* in Hiller v. Bank of Columbia, 92 S.C. 445, 75 S.E. 789 (1912). Although following *Simmons Hardware* and citing *Callahan*, the court, "[t]o avoid misunderstanding," made the following statement: "[T]he right of the depositor to demand his balance is subject to the right of the bank to set off against the balance any debt due by him to the bank . . . ." *Id.* at 448, 75 S.E. at 790. No mention was made of a requirement of notice or consent, and in the context of remanding for a new trial the court obviously intended to state the applicable law for guidance.

In a dictum three years later, the court clearly assumed that *Hiller* had brought the law in South Carolina into accord with the general rule: "*And, as there was no agreement, express or implied, forbidding it* . . . , the bank had the right to set off its debt to Wilkins for the amount of the deposit against Wilkins' debt to the bank." Southern Trust Co. v. Wilkins, 101 S.C. 457, 459, 86 S.E. 26, 27 (1915) (emphasis added).

There are no subsequent cases in which the issue is clearly raised, but neither is there any indication that the *Callahan* rule has survived.

22. Gonzalez & Co. v. Thomas, 42 Ariz. 308, 25 P.2d 552 (1933); Knapp v. Cowell, 77 Iowa 528, 42 N.W. 434 (1889).

banks can collect debts peremptorily, provided they are willing to antagonize customers in order to do so.

Since the right of setoff was recognized long before bank credit cards came into existence,[23] it obviously cannot be contended that the setoff doctrine as originally formulated was *intended* to encompass bank credit card debts. These debts, however, appear to comply with the criteria established by the courts when upholding setoff in more conventional circumstances:[24] (1) mutuality of obligation,[25] (2) maturity of the depositor's obligation,[26] and (3) certainty of the amount of the debt.[27]

Mutuality of obligation means essentially that the customer must be acting in the same capacity in his dual roles of depositor and debtor.[28] The mutuality concept can be made clearer by example than by further definition. A bank may not set off a partnership debt against the individual account of one partner, even though it might have a cause of action against the partner for the partnership debt;[29] nor may a bank set off against a joint account in the names of A and B a debt due from A individually.[30] These and other limitations[31] imposed by the mutuality requirement should apply in the particular case where the debt results from the use of a bank credit card, but they have no special effect on credit card setoff in general. In the most common situation an individual consumer maintains both a credit card and a deposit

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23. *Compare* the dates of the cases in note 17 *supra with* the text accompanying note 4 *supra.*

24. Setting off against a depositor's account when these criteria have not been met may subject the bank to tort liability for conversion. *See, e.g.*, James Mills Orchard Co. v. Bank of America Nat'l Trust & Sav. Ass'n, 137 Cal. App. 299, 30 P.2d 626 (1934); Black v. Whitewater Commercial & Sav. Bank, 188 Wis. 24, 205 N.W. 404 (1925).

25. John Wills, Inc. v. Citizens Nat'l Bank, 125 N.J.L. 546, 16 A.2d 804 (Ct. Err. & App. 1940); 5A MICHIE § 115c.

26. Gillett v. Williamsville State Bank, 310 Ill. App. 395, 34 N.E.2d 552 (1941); 5A MICHIE § 115b.

27. Tallapoosa County Bank v. Wynn, 173 Ala. 272, 55 So. 1011 (1911); 5A MICHIE § 119a.

28. "[T]he debts [must] be due to and from the same persons in the same capacity." Holloway v. First Nat'l Bank, 45 Idaho 746, 751, 265 P. 699, 700 (1928).

29. First Nat'l Bank v. Capps, 208 Ala. 207, 94 So. 109 (1922); Adams v. First Nat'l Bank, 113 N.C. 332, 18 S.E. 513 (1893). *Contra*, Owsley v. Bank of Cumberland, 23 Ky. L. Rptr. 1726, 66 S.W. 33 (Ct. App. 1902).

30. Peoples Bank v. Turner, 169 Md. 430, 182 A. 314 (1936). Although this result should follow from simple considerations of mutuality, there are so many exceptions and contrary holdings on particular facts that it cannot be called an accepted rule. *See generally* Annot., 118 A.L.R. 386 (1939); Annot., 103 A.L.R. 493 (1936).

31. *See* 5A MICHIE §§ 115c, 118c, 128-44.

account in his own name and for his own personal use, and mutuality of obligation clearly exists.

Similarly, the requirement that the depositor's debt must have matured is not an obstacle to credit card setoff. The problem of when maturity of the debt occurs is resolved by the credit agreement, which allows the cardholder twenty-five days from the billing date to make payment. The cardholder may either pay in full and thereby avoid a finance charge, or pay in part, subject to a specified minimum, and incur a finance charge on the balance. If he fails to make this minimum payment on time, the agreement permits the bank to accelerate the debt and declare all amounts due and payable.[32] At this time the cardholder's debt is mature for purposes of the setoff doctrine.

The requirement that the bank's claim be "certain, definite, and liquidated, or capable of liquidation by calculation without the intervention of a jury to estimate the sum"[33] is potentially more troublesome. By nature a debt resulting from the use of a credit card is neither as definite nor as incontrovertible as a note given to the bank—the transaction that originally spawned the setoff doctrine. The cardholder may dispute some mechanical aspect of the billing process: He may have been billed for a purchase on another card, billed an incorrect amount, or billed twice for the same purchase. The certainty of the debt may also be undermined when the cardholder, after discovering that the merchandise he obtained is defective, decides to withhold payment until the defect is satisfactorily remedied.

Banks attempt to avoid both of these potential uncertainties by a careful drafting of their cardholder agreements. With regard to mechanical billing disputes, they allow a specified period of

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32. The following statement is taken from a copy of the Master Charge credit agreement received with a Master Charge card:

> Notwithstanding anything herein, in the event of (a) default by Cardholder in making any payment when due and payable, . . . then, at Bank's option, all amounts due from Cardholder to Bank shall become immediately due and payable, *and any and all amounts due from Bank to Cardholder, including amounts on deposit with Bank, may be off-set and applied in satisfaction of Cardholder's indebtedness* . . . . In any such event Cardholder agrees to pay all costs of collection, including reasonable attorney's fees, incurred by Bank.

Master Charge Rules and Regulations and Cardholder Agreement ¶ 14 (no date indicated) (emphasis added) [hereinafter cited as Master Charge Agree.]. The BankAmericard agreement contains an analogous term but does not specifically mention the right of setoff. BankAmericard Retail Installment Credit Agreement ¶ 9 (Feb. 27, 1972) [hereinafter cited as BankAmericard Agree.].

33. 5A MICHIE § 119a.

time for a cardholder to examine his statement and notify the bank of any discrepancies or charges believed to be in error; the period generally allowed is fifteen days.[34] According to the cardholder agreements, a statement is deemed to be admitted if not challenged during the specified period. To preclude the possibility of a cardholder's withholding payment for defective merchandise or service, credit card agreements contain a "waiver-of-defense clause"[35] that insulates the issuing bank from warranty and similar defenses. Such a clause requires that the cardholder pay the bank in full and independently seek restitution or satisfactory performance from the merchant. If these two clauses are given effect as written, they render credit card debts certain within the meaning of common law setoff requirements.

The question in a given case thus becomes whether these clauses will be enforced by the courts. If they appeared in a contract resulting from true negotiation between parties of equal bargaining strength, such clauses would undoubtedly be upheld. Cardholder agreements, however, are non-negotiated "take -it-or-leave-it" contracts, and the clauses in question typically appear amidst boiler plate language which discourages scrutiny. Thus, courts might decline to give effect to such one-sided contract provisions on the grounds that enforcement would violate public policy or lead to an unconscionable result.[36]

34. The Master Charge agreement examined by the authors provides for a fifteen day period from the billing date, while the BankAmericard agreement allows fifteen days from receipt by the cardholder. *Compare* Master Charge Agree. ¶ 12 *with* BankAmericard Agree. ¶ 2(c).

35. The BankAmericard agreement examined by the authors includes the following provision:

> Issuer shall have no responsibility for any claim or cause of action arising out of, or in any way related to a Card Purchase which Buyer may have against any seller, including the refusal of any seller to honor the Card; Buyer agrees that his liability to Issuer for Card indebtedness is absolute and that Buyer will settle or redress any disputes directly with the seller.

BankAmericard Agree. ¶ 4.

36. The concept of a contract provision being unconscionable or a violation of public policy is not capable of objective definition. Perhaps the most famous case on this issue is Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A.2d 69 (1960), which involved a disclaimer of implied warranty of merchantability in the sale of an automobile. The court devoted many pages to this issue, mentioning the unequal bargaining power of the parties, the fact that all automobile manufacturers offered the same warranty terms, the fact that the clause undermined otherwise applicable law without any corresponding benefit to the consumer, the fine print in the contract, the failure to call attention to the clause and its meaning, the likelihood that the average consumer would not understand the clause, and the basic unfairness of its application. *Id.* at 385-404, 161 A.2d at 84-95.

For several reasons, the clause providing that the statement will be deemed correct after a stated period of time appears particularly vulnerable to challenges on these grounds. This time limitation is wholly self-serving on the part of the bank. In many cases it would allow the bank to profit from its own mistake without showing any harm occasioned by the cardholder's delay. Moreover, the fixed and inflexible time period conflicts with both the common law[37] and the Uniform Commercial Code,[38] which permit a customer a reasonable time under the circumstances within which to examine his checking account statement. The fifteen-day period typically allowed[39] might be challenged as too short, especially when compared with the twenty-five days allowed for payment. And, most fundamentally, the conclusive presumption of correctness conflicts directly with the common law rule governing checking accounts under which a customer's failure to notify the bank of errors in his statement creates only a presumption of correctness that can be overcome by specific evidence introduced during the course of the proceeding.[40] These factors suggest that time-limitation clauses may well be unenforceable.

It is not possible to isolate any subset of these factors as determinative of the clause's ultimate invalidity. The technique with regard to an issue of this sort is to examine the overall factual picture and draw a rather subjective final conclusion as to whether the clause will be enforced.

The Uniform Commercial Code adopts this approach in its article on sales by giving a court wide latitude in tailoring enforcement of a contract if "as a matter of law [it] finds the contract or any clause of the contract to have been unconscionable at the time it was made . . . ." UNIFORM COMMERCIAL CODE § 2-302(1). The only specific guide in the section itself is that the court is to hear evidence from both sides on the clause's "commercial setting, purpose and effect." The Code nowhere defines unconscionability and, indeed, provides a circular test for unconscionability in which the key operative word is "unconsionable." *Id.*, Comment 1.

37. Forbes v. First Camden Nat'l Bank & Trust Co., 25 N.J. Super. 17, 95 A.2d 416 (1953); Weck v. First Pa. Banking & Trust Co., 202 Pa. Super. 39, 195 A.2d 111 (1963). *See* 5B MICHIE § 308.

38. UNIFORM COMMERCIAL CODE § 4-406(1) states that a customer must exercise "reasonable care and promptness" in examining his statement and notifying the bank of unauthorized signatures or altered checks.

39. *See* note 34 *supra*.

40. Monier v. Guaranty Trust Co., 82 F.2d 252 (2d Cir.), *cert. denied*, 298 U.S. 670 (1936); Shipman v. Bank of State, 126 N.Y. 318, 27 N.E. 371 (1891). *See* 5B MICHIE § 308.

These clauses in bank credit card agreements could probably be interpreted by the courts to have only this limited result because their language is not precise. For example, the BankAmericard agreement examined by the authors provides only that the statement "shall be deemed admitted." *See* Kansas City Wholesale Grocery Co. v. Weber Packing Corp., 93 Utah 414, 73 P.2d 1272 (1937) (clause limiting time for complaints held inapplicable to latent defect which could not reasonably have been discovered within that time).

Waiver-of-defense clauses have been strongly attacked because they deprive purchasers of consumer goods and services of their one truly effective element of leverage—the right to withhold payment until they receive satisfactory performance.[41] This criticism is reflected by a proposed amendment to the Truth in Lending Act[42] that would severely limit a bank's ability to require payment by immunizing itself against claims or defenses resulting from disputed consumer transactions.[43] The contention that these challenges are serious enough to warrant invalidating waiver-of-defense clauses as contrary to public policy is premised

41. S. REP. No. 93-278, *supra* note 11, at 9-11; *Hearings on S. 652, supra* note 10, at 235 (statement of William F. Willier, Director, National Consumer Law Center); *id.* at 261-62 (statement of Fairfax Leary, Jr., Public Interest Research Group); *id.* at 283-85 (statement of Prof. John A. Spanogle); Comment, *Bank Credit Cards—Contemporary Problems*, 41 FORD. L. REV. 373 (1972); Note, *Preserving Consumer Defenses In Credit Card Transactions*, 81 YALE L.J. 287 (1971); *see* CONSUMER FIN. REP., *supra* note 14, at 34-38.

A synopsis of the consumer arguments presented is as follows: Fraudulent merchants use their bank credit card recognition as a badge of prestige and a sign of bank approval. If banks are insulated from responsibility and loss, they will be lax in selecting merchants to participate under their plans. Banks can eliminate many consumer complaints by screening participating merchants more carefully. Banks can also exert leverage on participating merchants by influencing them to respond to consumer complaints. Typically, there are clauses in the agreements with participating merchants allowing banks to charge back to the merchants any sales in which the merchant has not properly carried out his obligations to the consumer. The consumer generally has no other satisfactory remedy, since the cost of litigation usually exceeds the amount in dispute. The banks, however, can spread the costs of recovery and of unrecoverable losses over all the card users.

The banks' rejoinder to this argument might be as follows: A bank is simply not equipped to police merchants to any significant degree. The extra costs of attempting to screen and police merchants, plus the unrecoverable losses, could not be spread by a bank because state laws regulate finance charges. The bank credit card issuer-holder relationship is in reality a direct loan to the consumer, and the bank should not be responsible for use of the money. If the unpaid debt is shifted back to the merchant, he is in no better position than the consumer would be to counter unfounded claims—especially if the amount in question is relatively small, the consumer resides a great distance away, and the merchant extended credit to him solely on the basis of his possession of a bank card. *See Hearings on S. 652, supra* note 10, at 353-60 (Joint Bankers Association statement); Note, *supra*, 81 YALE L.J. 287.

42. 15 U.S.C. §§ 1601-65 (1970).

43. S. 2101, 93d Cong., 1st Sess. § 170 (1973). This bill contains detailed exceptions but basically would subject the bank to all non-tort claims and all defenses that the merchant would normally face, *unless* the transaction does not exceed fifty dollars or the cardholder lives in another state and more than 100 miles from the location of the transaction. These exceptions are a concession to the banks' position in an apparent attempt to aid passage of the bill. A comparable bill in the Ninety-Second Congress would have subjected banks to "all claims and defenses," S. 652, 92d Cong., 1st Sess. § 169 (1971), but it died in the House Banking and Currency Committee. S. REP. No. 93-278, *supra* note 11, at 29.

upon cases in which similar clauses were not enforced when invoked by assignees of consumer installment sales contracts.[44] One major distinction in credit card cases is that, instead of being an assignee closely associated with the seller and tainted by his wrongdoing,[45] a bank is a relatively independent third party whose function as the issuer of a credit card is technically that of a lender.[46] In addition, while in an installment sales situation a consumer has neither control over the assignment of his contract nor knowledge of who the assignee will be, a credit card purchaser is fully aware that his obligation is payable to the bank. Although these differences may prevent the bank credit card waiver-of-defense clauses from being labeled unconscionable or contrary to public policy, it is clear that a strong argument can be advanced for holding them invalid.

If either of these arguments were successfully presented in a given case, the credit card debt would no longer have the element of certainty required by the common law setoff doctrine, and any setoff which had been exercised by the bank would be invalid. It does not necessarily follow, however, that banks would be precluded from future use of setoff against credit card debts. Presumably, arbitrary time periods or absolute waiver-of-defense clauses would have to be deleted from credit card agreements, but the necessary level of certainty might still be attained simply by allowing the cardholder a reasonable period of time in which to inform the bank of any disputes.[47] The requirement that the debt be certain is a subjective test designed to measure a bank's actual knowledge, thus preventing the bank from settling known disputes by an exercise of its setoff power; a bank could never be absolutely certain that its customer did not have some possible defense requiring jury intervention. In the traditional application of setoff, the general utility of the practice has not been impaired

44. Fairfield Credit Corp. v. Donnelly, 158 Conn. 543, 264 A.2d 547 (1969); Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967). *See* Annot., 39 A.L.R.3d 518 (1971). For a succinct discussion of the "close connectedness" doctrine evolving from these decisions as the rationale for stripping "interested" purchasers of chattel paper of their holder in due course status, *see* J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE § 14-8, at 479-84 (1972).

45. *See, e.g.*, Unico v. Owen, 50 N.J. 101, 232 A.2d 405 (1967).

46. *See* UNIFORM CONSUMER CREDIT CODE § 1.301(9); *id.* § 3.106, Comment.

On the other hand, it might be claimed that the bank's selection of the merchant for plan participation and its appearance of approval of the merchant's business practices sufficiently connect the bank to the merchant's wrongdoing.

47. *See* notes 37 and 38 and accompanying text *supra*.

by the fact that there have been individual cases in which its use was forbidden. Although arguments that credit card debts are uncertain may be successful, especially if waiver-of-defense clauses are legislatively or judicially forbidden, these arguments do not undermine the entire practice of bank credit card setoff.

One further point may be made regarding the common law setoff requirements. It is clear that the traditional guidelines were propounded at a time long before the question of bank credit card setoff could possibly have arisen.[48] A court might therefore be receptive to the argument that, because a bank credit card system is a new and distinctive bank operation, traditional setoff guidelines should not be conclusive. In other words, the court might evaluate the desirability of banking setoff on its own merits free from binding precedent. The common law validity of bank credit card setoff may thus remain open to at least some doubt.

III. CONSTITUTIONAL DUE PROCESS

Setoff by a bank against a customer's deposit account is usually a summary proceeding since there is no requirement that the customer receive notice or a prior hearing on the merits of the bank's claim.[49] Any such proceeding must be considered suspect today in light of a succession of recent Supreme Court decisions striking down summary actions for violating the due process clause of the fourteenth amendment.[50] If banks continue to use their setoff power, they will undoubtedly be called upon to justify it in terms of the constitutional principles underlying these decisions.[51]

The cases most analogous to the question of banking setoff are *Sniadach v. Family Finance Corp.*[52] and *Fuentes v. Shevin*,[53]

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48. *See* note 23 *supra*.

49. This is true regardless of whether the customer's debt to the bank has arisen through use of a bank credit card or otherwise, and this discussion of constitutional issues thus applies to any summary banking setoff.

50. Sniadach v. Family Fin. Corp., 395 U.S. 337 (1969) (Wisconsin's prejudgment wage garnishment procedure); Goldberg v. Kelly, 397 U.S. 254 (1970) (New York City's termination of welfare payments); Bell v. Burson, 402 U.S. 535 (1971) (Georgia's suspension of drivers' licenses on a "fault" basis); Fuentes v. Shevin, 407 U.S. 67 (1972) (Florida's and Pennsylvania's replevin processes).

51. One commentator, writing before *Fuentes* was decided, concluded that summary banking setoff is constitutionally invalid. Note, *Banking Setoff: A Study in Commercial Obsolescence*, 23 HASTINGS L. REV. 1585, 1602-10 (1972) [hereinafter cited as *Hastings Note*].

52. 395 U.S. 337 (1969).

53. 407 U.S. 67 (1972).

both of which involved summary action in commercial contexts for the benefit of private parties. *Fuentes* is undoubtedly the leading authority because of its more detailed opinion, its more recent date, and its elaboration of the *Sniadach* holding.[54] The lower courts have already interpreted *Fuentes* to require notice and an opportunity for a prior hearing in a number of established commercial proceedings. Among the summary practices which have been held to be violative of due process for failure to comply with these requirements are replevin,[55] prejudgment attachment of property,[56] prejudgment garnishment of bank accounts,[57] a landlord's lien or right of distraint,[58] and a garageman's lien.[59] From the viewpoint of the individual against whom these practices are used, the key factor is that he is precluded from presenting his side of the story prior to a deprivation of the use of his "property." In this respect the practices are similar in nature to banking setoff. Although this analogy is attractive at first glance, it should not be allowed to detract from the true legal issue involved: Does summary banking setoff violate the due process clause of the fourteenth amendment?

According to the relevant language of the fourteenth amendment, no state shall deprive any person of property without due process of law. Assuming that *Fuentes* has established the minimum standards for due process in the commercial context, the problem becomes whether in a given case there has been a deprivation of a property interest which does not comply with these standards. If so, the remaining question is whether there was

54. *Id.* at 88-89.

55. Turner v. Colonial Fin. Corp., 467 F.2d 202 (5th Cir. 1972); Mitchell v. Tennessee, 351 F. Supp. 846 (W.D. Tenn. 1972); Thorp Credit, Inc. v. Barr, 200 N.W.2d 535 (Iowa 1972).

56. Bay State Harness Horse Racing & Breeding Ass'n v. PPG Indus., Inc., 42 U.S.L.W. 2132 (D. Mass., Aug. 7, 1973); Lake Arrowhead Estates, Inc. v. Cumming, 42 U.S.L.W. 2035 (D. Me., June 25, 1973); McClellan v. Commercial Credit Corp., 350 F. Supp. 1013 (D.R.I. 1972); Etheredge v. Bradley, 502 P.2d 146 (Alas. 1972).

57. Western Coach Corp. v. Shreve, 475 F.2d 754 (9th Cir. 1973); Schneider v. Margossian, 349 F. Supp. 741 (D. Mass. 1972); Brunswick Corp. v. Galaxy Cocktail Lounge, Inc., 42 U.S.L.W. 2175 (Hawaii, Sept. 7, 1973).

58. Hall v. Garson, 468 F.2d 845 (5th Cir. 1972); Barber v. Rader, 350 F. Supp. 183 (S.D. Fla. 1972); Gross v. Fox, 349 F. Supp. 1164 (E.D. Pa. 1972); MacQueen v. Lambert, 348 F. Supp. 1334 (M.D. Fla. 1972); Shaffer v. Holbrook, 346 F. Supp. 762 (S.D.W. Va. 1972); Dielen v. Levine, 344 F. Supp. 823 (D. Neb. 1972); Blye v. Globe-Wernicke Realty Co., 42 U.S.L.W. 2072 (N.Y., July 13, 1973).

59. Hernandez v. European Auto Collision, Inc., 42 U.S.L.W. 2062 (2d Cir., June 29, 1973); Mason v. Garris, 42 U.S.L.W. 2005 (N.D. Ga., June 21, 1973); Straley v. Gassaway Motor Co., 42 U.S.L.W. 2006 (S.D.W. Va., June 6, 1973).

sufficient state involvement in the deprivation to bring it within the prohibitions of the amendment.

There can be no serious doubt that removing funds from a customer's deposit account deprives him of "property" within the meaning of the due process clause. While a customer does not retain title to the funds he deposits in a bank, he does become a creditor to whom the bank owes a debt;[60] this debt is as much a property interest as the unpaid wages earned by the employee in *Sniadach*. Banking setoff operates to deprive the depositor of this intangible property interest just as the garnishment in *Sniadach* deprived the employee of hers. Although *Fuentes* involved chattels in the possession of the individuals, the Court was careful to point out that the requirement of "[property] has been read broadly to extend protection to 'any significant property interest.'"[61] Furthermore, the lower courts which have relied on *Fuentes* in dealing with prejudgment garnishment of bank accounts have not even felt it necessary to comment on the question of whether a bank account constitutes "property" within the meaning of the fourteenth amendment.[62]

The difficulty arises in consideration of the other requisite to invoking the due process clause: state action. The Supreme Court has not yet reached the question of the state action requirement in the area of summary commercial practices; this was not at issue in either *Fuentes* or *Sniadach*, where the state action was clear and unquestioned.[63] The lower courts, however, have faced the state action issue, and the results have been far from unanimous. For example, the question has been frequently raised in the area of self-help repossession by a secured party pursuant to section 9-503 of the Uniform Commercial Code (UCC).[64] The issue

60. *See* cases cited note 18 *supra*.

61. 407 U.S. at 86.

62. *See* cases cited note 57 *supra*.

63. In *Fuentes* the Florida and Pennsylvania replevin statutes authorized state agents to make the actual seizure of possessions. 407 U.S. at 73-78. In *Sniadach* the garnishee summons was issued by the clerk of court. 395 U.S. at 338-39.

The Court in *Fuentes* did touch on the question of state action in a footnote: "The creditor could, of course, proceed without the use of state power, through self-help, by 'distraining' the property before a judgment." 407 U.S. at 79 n.12. This statement is located in a discussion of the historical development of replevin, however, and probably was not intended to have other than historical significance.

64. UNIFORM COMMERCIALCODE § 9-503 provides in part:

Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without is whether the mere enactment of this section constitutes sufficient action by the state to invoke the prohibitions of the fourteenth amendment. The ninth circuit, the only court of appeals to have squarely confronted the question at this time, has ruled that enactment is not sufficient state action.[65] Prior to this decision, the federal district courts had split almost evenly on the issue,[66] while the state courts had been unanimous in holding that there was no state action.[67]

The cases finding sufficient state involvement tend to rely heavily on *Reitman v. Mulkey*.[68] That decision held unconstitutional under the equal protection clause a section of the California Constitution prohibiting restrictions on an individual's right to refuse to sell property to anyone for any reason. The purpose and effect of that section was to invalidate certain existing antidiscriminatory housing acts and to preclude any such future enactments. The Supreme Court phrased the question in terms of whether the section "would encourage and significantly involve the State in private racial discrimination."[69] Following this rationale, some courts have held that by enacting section 9-503 of the UCC, the state is in effect establishing a state policy favoring self-help repossessions, thus encouraging and becoming significantly involved in such repossessions.

The courts reaching the opposite conclusion tend to distin-

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judicial process if this can be done without breach of the peace or may proceed by action.

65. Adams v. Southern Cal. First Nat'l Bank, 42 U.S.L.W. 2231 (9th Cir., Oct. 4, 1973).

66. State action: Boland v. Essex County Bank & Trust Co., 42 U.S.L.W. 2116 (D. Mass., Aug. 15, 1973); James v. Pinnix, No. 72J-250(N) (S.D. Miss., Feb. 14, 1973); Michel v. Rex-Noreco, Inc., No. 6729 (D. Ver., Nov. 1, 1972); Adams v. Egley, 338 F. Supp. 614 (S.D. Cal. 1972).

No state action: Colvin v. Avco Fin. Servs., No. 35-72 (N.D. Utah, Jan. 4, 1973); Kirksey v. Theilig, 351 F. Supp. 727 (D. Colo. 1972); Pease v. Havelock Nat'l Bank, 351 F. Supp. 118 (D. Neb. 1972); Greene v. First Nat'l Exch. Bank, 348 F. Supp. 672 (W.D. Va. 1972); Oller v. Bank of America, 342 F. Supp. 21 (N.D. Cal. 1972).

67. Northside Motors, Inc. v. Brinkley, No. 43,401 (Fla., July 31, 1973); Messenger v. Sandy Motors, Inc., 121 N.J. Super. 1, 295 A.2d 402 (1972); Brown v. United States Nat'l Bank, No. 10,100 (Ore., Apr. 19, 1973); Plante v. Industrial Nat'l Bank, No. 73-714 (R.I. Super. Ct., Apr. 4, 1973).

It should be noted that some of the decisions finding no state action were framed in jurisdictional terms; that is, they decided that the actions were not "under color of state law" as required by 42 U.S.C. § 1983 (1970). While the two concepts are not necessarily identical, it would seem that in this context an action found not even to be "under color of state law" could hardly be "state action."

68. 387 U.S. 369 (1967).

69. *Id.* at 376.

guish *Reitman* on two grounds.[70] First, *Reitman* dealt with the sensitive area of racial discrimination, in which the courts are alert to discover subtle state action tending indirectly to encourage discrimination or to circumvent individual rights. Second, there was a greater degree of state involvement in *Reitman* because the constitutional provision authorized previously prohibited discrimination rather than merely codifying an existing right.

Regardless of the eventual resolution of this question, banking setoff stands on a significantly sounder constitutional footing than does self-help repossession under the UCC since setoff is generally not a codified remedy but rather a common law right based on the mutual debtor-creditor relationship between the parties.[71] Some states have statutes concerning banker's liens,[72] but these refer to liens on securities or commercial paper deposited with the bank, whereas setoff against a customer's account is entirely different.[73] The UCC, while recognizing the possible existence of the setoff practice,[74] does not attempt to define, authorize, or legitimize it in any way. And although a statutory provision incorporating the English common law[75] is some state endorsement of a right such as setoff, it is clearly not state involvement or encouragement of the substantial nature contem-

70. *E.g.*, Adams v. Southern Cal. First Nat'l Bank, 42 U.S.L.W. 2231 (9th Cir. Oct. 4, 1973); Kirksey v. Theilig, 351 F. Supp. 727, 731-32 (D. Colo. 1972).

71. *See* cases cited note 18 *supra*. *See generally* 5A MICHIE § 114. For exceptions where setoff has been codified, see N.D. CENT. CODE § 6-03-67 (1959) and LA. CIV. CODE art. 2210 (1952). Both of these statutes, however, place so many restrictions on setoff that due process requirements pose no problems.

72. *E.g.*, CAL. CIV. CODE § 3054 (West 1954).

73. Gonsalves v. Bank of America Nat'l Trust & Sav. Ass'n, 16 Cal. 2d 169, 173, 105 P.2d 118, 121 (1940).

74. Section 4-201(1) refers to "rights of a collecting bank such as those resulting from outstanding advances on the item and valid rights of setoff;" by using the adjective "valid" the section avoids expanding existing setoff doctrine. Section 4-303(1) mentions setoff in order to specify when it is too late for banks to exercise such a right if it does exist; the section recognizes the state's jurisprudence by the qualifying phrase "whether or not effective under other rules of law." Section 9-104(i) expressly excludes "any right of setoff" from the coverage of article 9 on secured transactions.

75. *E.g.*, CAL. CIV. CODE § 22.2 (West 1954).

The Uniform Commercial Code contains a somewhat similar provision in section 1-103: "Unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant and the law relative to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, bankruptcy, or other validating or invalidating cause shall supplement its provisions."

plated by *Reitman*.[76] It would appear that banking setoff is not subject to due process requirements under the theory that state enactment is sufficient state action.

However, the federal courts have formulated another standard for cases in which there is no specific state action among the acts complained of, but the state is nevertheless so involved that the fourteenth amendment should control the conduct under consideration. This "public function" doctrine was first introduced by the Supreme Court in 1946 in *Marsh v. Alabama*,[77] involving a private company town that refused to allow distribution of religious literature. It has since been applied by the Court to cases involving a private park whose management was closely entwined with municipal control,[78] a private restaurant leasing city property and discriminating on a racial basis,[79] a shopping center preventing peaceful picketing,[80] and a political party prohibiting Negroes from voting in an "advisory" primary prior to a state-controlled Democratic primary.[81] The limits of this doctrine are not precisely defined; one of the more precise statements of its meaning was given in *Evans v. Newton*,[82] the private park case:

> Conduct that is formally "private" may become so entwined with governmental policies or so impregnated with a governmental character as to become subject to the constitutional limitations placed upon state action . . . . That is to say, when private individuals or groups are endowed by the State with powers or functions governmental in nature, they become agencies or instrumentalities of the State and subject to its constitutional limitations.[83]

Several lower federal courts have recently considered a fact situation that arguably falls within the "public function" doc-

76. "This is not the final answer to the touchstone of state action. Were such a test the only one, the California statutes adopting the common law of England would cast the shadow of state action over all activity and pose an argument that could blanket all individual wrongs under [42 U.S.C. §] 1983." Adams v. Southern Cal. First Nat'l Bank, 42 U.S.L.W. 2231 (9th Cir. Oct. 4, 1973).

77. 326 U.S. 501 (1946).

78. Evans v. Newton, 382 U.S. 296 (1966).

79. Burton v. Wilmington Parking Authority, 365 U.S. 715 (1961).

80. Amalgamated Food Employees Union Local 590 v. Logan Valley Plaza, 391 U.S. 308 (1968). *But see* Lloyd Corp. v. Tanner, 407 U.S. 551 (1972).

81. Terry v. Adams, 345 U.S. 461 (1953) (opinion of Mr. Justice Clark).

82. 382 U.S. 296 (1966).

83. *Id.* at 299.

trine, although most of them did not discuss the doctrine explicitly.[84] This situation involves the question of whether a public utility company is acting under color of state law when it discontinues service to a customer for alleged failure to pay his bills. Most of the courts considering this issue have found the necessary degree of state involvement.[85] There are strong similarities to the banking setoff fact situation here. In both situations a private corporation is able to deprive the customer of his "property" without the intervention of the state or any other third party and without even having to come in contact with the customer or any other property belonging to him.[86] The public utility cases emphasize the pervasive nature of the state regulation, which is certainly present in the banking industry as well.[87]

On the other hand there are also important differences between the two situations. Many of the public utility cases are clearly distinguishable because of the existence of state statutes authorizing the discontinuance of service,[88] or because of other factual matters.[89] Of greater significance, however, is that all the

84. One which does discuss it is Ihrke v. Northern States Power Co., 459 F.2d 566, 569 (8th Cir.), *vacated as moot*, 409 U.S. 815 (1972).

85. Ihrke v. Northern States Power Co., 459 F.2d 566 (8th Cir.), *vacated as moot*, 409 U.S. 815 (1972); Bronson v. Consolidated Edison Co., 350 F. Supp. 443 (S.D.N.Y. 1972); Hattell v. Public Serv. Co., 350 F. Supp. 240 (D. Colo. 1972); Stanford v. Gas Serv. Co., 346 F. Supp. 717 (D. Kan. 1972); Palmer v. Columbia Gas Co., 342 F. Supp. 241 (N.D. Ohio 1972). *Contra*, Lucas v. Wisconsin Elec. Power Co., 466 F.2d 638 (7th Cir. 1972), *cert. denied*, 409 U.S. 1114 (1973).

86. Some of the public utility cases discuss the trespass by the utility's employees on the customer's land when disconnecting his service. Bronson v. Consolidated Edison Co., 350 F. Supp. 443, 446 (S.D.N.Y. 1972); Palmer v. Columbia Gas Co., 342 F. Supp. 241, 245-46 (N.D. Ohio 1972). Only one case treats it as a crucial factor. Hattell v. Public Serv. Co., 350 F. Supp. 240, 245 (D. Colo. 1972). The others do not even mention whether such a trespass has occurred.

87. *E.g.*, S.C. CODE ANN. §§ 8-101 to -317 (1962); UNIFORM COMMERCIAL CODE art. 4.

88. *See* Bronson v. Consolidated Edison Co., 350 F. Supp. 443, 446 (S.D.N.Y. 1972); Palmer v. Columbia Gas Co., 342 F. Supp. 241, 245 (N.D. Ohio 1972). In Lucas v. Wisconsin Elec. Power Co., 466 F.2d 638 (7th Cir. 1972), *cert. denied*, 409 U.S. 1114 (1973), there was no statute but there was a regulation of the state Public Service Commission containing such authorization. *Id.* at 641-42. In the face of this regulation, the court nonetheless held there was insufficient state involvement to constitute state action.

The issue in these cases more closely resembles the question of whether legislative enactment of section 9-503 of the UCC constitutes state action.

89. In one case the fact that the utility's employees had entered private property to cut off the service seemed to be a critical factor. Hattell v. Public Serv. Co., 350 F. Supp. 240, 245 (D. Colo. 1972); *see* note 86 *supra*. In another case, there was an unusually close relationship between the utility and a municipality—the city received 5% of the utility's gross earnings, and it also exercised a statutory authority to review the utility's regulations with the right of approval, rejection, or revision. Ihrke v. Northern States Power Co., 459 F.2d 566, 568-70 (8th Cir.), *vacated as moot*, 409 U.S. 815 (1972).

cases emphasize that the public utility has been granted a monopoly in its geographic area as a result of clear state action,[90] while banks enjoy no such monopoly.[91] Thus the public utility question, which itself has not been conclusively resolved,[92] presents an interesting analogy to the banking setoff question but hardly appears to dictate the solution.

One author has suggested that because of the nature of the banking business and the degree of state control and regulation, the "public function" doctrine may be applicable.[93] If this were true, the key factor would seemingly have to be the state regulation, because banking surely is not an inherently public operation in the same sense as the operation of parks and company towns. The idea that regulation alone can involve the state in otherwise private activity to the extent contemplated by the fourteenth amendment has been limited, however, by the recent case of *Moose Lodge No. 107 v. Irvis*:[94]

> The District Court was at pains to point out in its opinion what is considered to be the "pervasive" nature of the regulation of private clubs by the Pennsylvania Liquor Control Board . . . .
>
> However detailed this type of regulation may be in some particulars, it cannot be said to in any way foster or encourage

90. "[T]he state has in effect granted monopoly protection to Wisconsin Electric. . . . Customers, like plaintiff, are therefore denied the practical and often effective remedy of taking their patronage elsewhere when treated unfairly by a supplier." Lucas v. Wisconsin Elec. Power Co., 466 F.2d 638, 656 (7th Cir. 1972), *cert. denied*, 409 U.S. 1114 (1973). *See also* Ihrke v. Northern States Power Co., 459 F.2d 566, 570 (8th Cir.), *vacated as moot*, 409 U.S. 815 (1972) ("could not buy these commodities from any other source"); Stanford v. Gas Serv. Co., 346 F. Supp. 717, 722 (D. Kan. 1972) ("enjoy a complete monopoly of supplying an essential commodity to the citizens").

91. The result of the public utility monopoly is that the individual customer cannot obtain his utility service from any other source. In effect, granting this monopoly precludes the customer from taking his business elsewhere and arguably involves the state with the practices of the monopolistic utility to a sufficient degree to constitute state action. In the banking field, however, though the state certainly limits the customer's alternatives by restricting entry into the field (*see, e.g.*, S.C. CODE ANN. § 8-57 (1962)), there is no state-created monopoly. A customer may be somewhat inconvenienced, but he can always change banks if he is dissatisfied with the service he receives. The practice of banking setoff does not combine with the state licensing action to deny banking services to the customer altogether, as in the public utility cases.

92. While only one federal court has found that no state action exists, it was a circuit court sitting en banc, and there were only two dissents. Certiorari has been denied by the Supreme Court. Lucas v. Wisconsin Elec. Power Co., 466 F.2d 638 (7th Cir. 1972), *cert. denied*, 409 U.S. 1114 (1973).

93. *Hastings Note*, *supra* note 51, at 1604.

94. 407 U.S. 163 (1972).

> racial discrimination. Nor can it be said to make the State in any realistic sense a partner or even a joint venturer in the club's enterprise.[95]

Can the state's regulation of banking institutions be said to "foster or encourage" banking setoff? It would seem not; banking setoff is merely a commercial tool being employed by a private body, unaffected one way or the other by state regulation of other aspects of its business. To label this state action would be a misnomer. It is in reality state *inaction* in an area where the state could act but has chosen not to do so. To bring this situation under the language of the fourteenth amendment would certainly be an unprecedented step.

It thus appears that summary banking setoff, in spite of its practical similarities to such constitutionally prohibited practices as prejudgment garnishment of bank accounts without a hearing, is not itself a violation of the due process clause. If the practice is to be prohibited, it will have to be done by the legislative branch of the government.

IV. LEGISLATIVE CONTROLS

A. *Truth in Lending Act*

There is no existing federal legislation that can be interpreted to prohibit the practice of banking setoff of credit card debts. The 1968 Consumer Credit Protection Act,[96] however, imposes various controls on the credit card industry. Of particular interest is subchapter I of that legislation, the Truth in Lending Act,[97] which is designed "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."[98] Specific provisions of the Act must be examined to determine whether banking setoff is one of the "credit terms" that must be revealed to potential cardholders in a "meaningful" manner.[99]

Because a bank credit card system clearly falls within the

95. *Id.* at 176-77.
96. 15 U.S.C. §§ 1601-81 (1970), *as amended.*
97. *Id.* §§ 1601-65 (1970).
98. *Id.* § 1601 (1970).
99. Some banks already make a limited disclosure of the existence of a right of setoff while others do not. *See* note 32 *supra.*

Act's definition of an "open end credit plan,"[100] a bank must apprise its customers of the circumstances leading to the imposition of a finance charge, the methods of computing the balance and the charge applicable to it, and any fixed or minimum charges.[101] In addition there must be disclosure of "[t]he conditions under which the creditor may retain or acquire any security interest in any property to secure the payments of any credit extended under the plan, and a description of the interest or interests which may be so retained or acquired."[102] The question thus narrows to whether a bank's right of setoff against a deposit account is a "security interest in any property to secure the payments of any credit extended . . . ."

Although the Act itself does not define "security interest," it does delegate to the Federal Reserve Board the power and duty to prescribe rules necessary to prevent evasion of the Act and to effect its purposes.[103] Under this authority the Board has promulgated regulation Z,[104] which defines "security interest" as follows:

> "Security interest" and "security" mean any interest in property which secures payment or performance of an obligation. The terms include, but are not limited to, security interests under the Uniform Commercial Code, real property mortgages, deeds of trust, and other consensual or confessed liens whether or not recorded, mechanic's, materialmen's, artisan's, and other similar liens, vendors's liens in both real and personal property, the interest of a seller in a contract for the sale of real property, any lien on property arising by operation of law, and any interest in a lease when used to secure payment or performance of an obligation.[105]

Even under this comprehensive definition, however, the right of setoff does not appear to qualify as a security interest.

Regulation Z lists several specific liens which are to be con-

100. 15 U.S.C. § 1602(i) (1970) reads as follows:
The term"open end credit plan" refers to a plan prescribing the terms of credit transactions which may be made thereunder from time to time and under the terms of which a finance charge may be computed on the outstanding unpaid balance from time to time thereunder.
101. *Id.* § 1637 (1970).
102. *Id.* § 1637(a)(7) (1970).
103. *Id.* § 1604 (1970).
104. 12 C.F.R. § 226.2(z) (1973).
105. *Id.*

sidered security interests, and it also includes the more general categories of "other consensual or confessed liens" and "any lien on property arising by operation of law." The question of whether the right of setoff could be considered a lien within this definition is unnecessarily complicated by the fact that some courts have referred to setoff as a banker's lien.[106] As mentioned earlier,[107] however, such statements are inaccurate. The concept of banker's lien properly applies to those cases in which the bank has possession of securities or commercial paper belonging to the customer, under the theory that the bank relies upon its possession of these specific items as security for its advances or extensions of time to the customer.[108] When the issue has been presented, banking setoff has been clearly distinguished from the banker's lien.[109] The most obvious ground for this distinction is that the bank becomes the owner of funds on deposit and cannot have a lien on its own property.[110] More generally, setoff is a one-step process of cancel-

106. *E.g.*, Batson v. Alexander City Bank, 179 Ala. 490, 497, 60 So. 313, 315 (1912); McStay Supply Co. v. John S. Cook & Co., 35 Nev. 284, 297, 132 P. 545, 548 (1913).

107. *See* note 73 and accompanying text *supra*.

108. Reynes v. Dumont, 130 U.S. 354, 391-92 (1889) (dicta); Goggin v. Bank of America Nat'l Trust & Sav. Ass'n, 183 F.2d 322 (9th Cir.), *cert. denied*, 340 U.S. 877 (1950).

109. Gonsalves v. Bank of America Nat'l Trust & Sav. Ass'n, 16 Cal. 2d 169, 105 P.2d 118 (1940). The same distinction is made in 5A MICHIE § 114: "[W]hile it is sometimes said that a bank has a lien on the deposits for this purpose, the more accurate statement is that this right of the bank is not a lien or in the nature of a lien, but a right of set-off, or of an application of payments." A concise and well-documented discussion of the distinction also appears in Note, *Right of Bank to Set Off Deposit against a Depositor's Debt Despite Undisclosed Equity*, 38 HARV. L. REV. 800 (1925).

It could be argued to the contrary that, since setoff has so often been referred to as a lien, it should be considered the equivalent of a lien for the remedial purposes of the Truth in Lending Act. The Harvard Law Review Note lends some support to this position: "The bank's right of set-off has transcended procedural significance, however, and despite the distinctions alluded to, courts and the commercial world treat it as substantially equivalent to a banker's lien." *Id.* at 800-01. This is apparently the position implicitly adopted in *Hastings Note, supra* note 51, at 1596-97. The author quotes authority to the effect that banking setoff is *in the nature of* a lien or security interest, from which he concludes that it is within the regulation Z definition. The argument is not persuasive, however. The authorities referring to setoff as a lien have done so in contexts where the label was completely unimportant (*see* cases cited note 106 *supra*), while the writers and other authorities have been careful to maintain the doctrinal distinction. To base a decision upon dicta and careless language rather than upon holdings and documented logical distinctions would hardly be good judicial practice. This is not to say that such a result would be contrary to the purposes of the Truth in Lending Act, but rather that the definition of setoff and the language of the Act would have to be stretched too much to reach this result. The preferable solution would be a legislative revision of the Act. *See also* note 118 *infra*.

110. Gonsalves v. Bank of America Nat'l Trust & Sav. Ass'n, 16 Cal. 2d 169, 173, 105 P.2d 118, 121 (1940); Note, *supra* note 109.

ling one contract debt against another;[111] there is no prior charge upon particular property for the payment of a particular debt[112] and no prior limitation on the customer's use of the deposited funds,[113] as would be present in the case of a lien. Similarities notwithstanding, banking setoff is simply not a lien.

Nor is setoff a security interest under the Uniform Commercial Code. The basic UCC definition of security interest is very similar to that of regulation Z: "an interest in personal property or fixtures which secures payment or performance of an obligation."[114] But article 9, which deals specifically with secured transactions, excludes from its coverage "any right of set-off."[115] The official comment explaining this exception is worth noting: "The remaining exclusions go to other types of claims which do not customarily serve as commercial collateral: judgments under paragraph (h), set-offs under paragraph (i) and tort claims under paragraph (k)."[116] Although this comment does not state categorically that setoff is not a security interest, it is a compelling indication that the Code draftsmen considered setoff to be an entirely different kind of claim.

The regulation Z definition, however, is purposefully broad and is not limited to enumerated examples such as liens and UCC security interests. Thus, the basic test is whether setoff is "any interest in property which secures payment or performance of an obligation." The concept of securing payment has traditionally meant guaranteeing payment, making an adequate pledge of payment, or in some other way making payment certain.[117] A customer's deposit account does not serve this purpose, for it is neither the theoretical nor the functional equivalent of collateral. No provision in the standard bank credit card agreements requires a customer to open an account with the issuing bank or even to maintain a specified balance in a preexisting account. Whether

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111. *See* notes 17-22 and accompanying text *supra*.

112. A lien is "a charge upon a particular piece of property, including realty, for the payment or discharge of a particular debt or duty in priority to the general debts or duty of the owner." Camden County Welfare Bd. v. Federal Dep. Ins. Corp., 1 N.J. Super. 532, 546, 62 A.2d 416, 422 (1948).

113. "The purpose of a lien is to limit the use of the property upon which a lien is placed, so as to provide security for the payment of a claim." Kerr v. Bowers, 48 F.2d 227, 232 (S.D.N.Y. 1931).

114. UNIFORM COMMERCIAL CODE § 1-201(37).

115. *Id.* § 9-104(i).

116. *Id.* § 9-104, Comment 8.

117. *See* United States v. Jacobs, 304 F. Supp. 613, 618 (S.D.N.Y. 1969).

a cardholder will have funds on deposit when his credit card debt matures is entirely beyond the bank's control; such a fortuitous circumstance hardly coincides with accepted notions of securing payment. It thus appears that banking setoff is not a security interest within the regulation Z definition and consequently is not covered by the present disclosure requirements of the Truth in Lending Act.[118]

B. Uniform Consumer Credit Code

The only other general legislation potentially applicable to setoff is the Uniform Consumer Credit Code (UCCC), which has been adopted by only a few states.[119] Even where adopted, the UCCC does no more to curtail banking setoff of credit card debts than does the Truth in Lending Act.

The UCCC differentiates between two classes of credit card arrangements—the seller credit card and the lender credit card. A seller credit card is one that permits cardholders to purchase only from the issuer or related concerns;[120] obvious examples are department store charge cards and gasoline credit cards.[121] The lender credit card is essentially a loan agreement in which the issuer contracts to pay the cardholder's debts to specified third parties.[122] Within this class are the three-party credit card systems of banks and other independent companies such as American Express.[123] A lender credit card is also defined in both common parlance and the UCCC as a revolving loan account.[124]

In spite of this detailed terminology, the disclosure provi-

118. This conclusion is indirectly supported by hearings held before a Senate committee investigating a bill that would have prohibited a bank from setting off a customer's credit card debt against his deposit account. *Hearings on S. 652, supra* note 10. Several witnesses made the point that setoff is particularly unfair and unreasonable because the consumer is always unaware of the bank's power until it is exercised against him. *Id.* at 236 (statement of Prof. William F. Willier, Director, Nat'l Consumer Law Center); *id.* at 272 (statement of Susan First, General Counsel, N.Y.C. Dep't of Consumer Affairs); *id.* at 288 (statement of Betty Furness). Yet at no time during the hearings did anyone suggest that banks are already required to make a "meaningful disclosure" of the setoff right under the Truth in Lending Act.

119. As of January, 1974, the UCCC is in effect in only seven states: Colorado, Idaho, Indiana, Kansas, Oklahoma, Utah, and Wyoming. 1 CCH 1973 CONSUMER CREDIT GUIDE ¶ 4770 (1974).

120. UNIFORM CONSUMER CREDIT CODE § 1.301(16) [hereinafter cited as UCCC].

121. *Id.* § 1.301(16), Comment.

122. *Id.* § 1.301(9).

123. *Id.* § 1.301(9), Comment.

124. *Id.* § 3.108, Comment.

sions for both classes of credit cards are nearly identical and are very similar to those in the Truth in Lending Act.[125] To comply with section 3.309(1)(g) of the UCCC, the issuer of a lender credit card must disclose "conditions under which the lender may retain or acquire a security interest in property to secure the balances resulting from loans made pursuant to the revolving loan account, and a description of the interest or interests which may be retained or acquired."[126] The UCCC contains no other definition of security interest. Thus, section 3.309(1)(g) is certainly no more inclusive than its counterpart in the Truth in Lending Act, which, even with the administrative gloss of regulation Z, apparently does not require banks to disclose their power of setoff.

C. *Proposed Legislative Controls*

Legislation has been introduced in the United States Senate that would eliminate most of the controversy surrounding banking setoff of credit card indebtedness. The pending bill[127] contains amendments of several kinds to the Truth in Lending Act. Title 1, entitled "Fair Credit Billing," would resulate credit cards and revolving charge accounts. Setoff is explicitly covered by section 169, which reads:

> Prohibition of offsets
> (a) A card issuer may not take any action to offset a cardholder's indebtedness arising in connection with a consumer credit transaction under the relevant credit card plan against funds of the rardholder held on deposit with the card issuer unless—
>> (1) such action was previously authorized in writing by the cardholder in accordance with a credit plan whereby the cardholder agrees periodinally to pay debts incurred in his open end credit account by permitting the card issuer periodically to deduct all or a portion of such debt from the cardholder's deposit account, and
>> (2) such action with respect to any outstanding disputed amount not be taken by the card issuer upon request of the cardholder.
>>
>> . . . .

125. *Compare* UCCC § 2.310 (seller credit card) *with id.* § 3.309 (lender credit card) *and* 15 U.S.C. § 1637 (1970) (Truth in Lending Act).
126. UCCC § 3.309(1)(g).
127. S. 2101, 93d Cong., 1st Sess. (1973).

(b) This section does not alter or affect the right under State law of a card issuer to attach or otherwise levy upon funds of a cardholder held on deposit with the card issuer if that remedy is constitutonally available to creditors generally.

Disclosure obviously pales beside this bill's objectives, for section 169 is intended to eliminate the favored position now occupied by banks as compared with cardholders' other creditors.[128] A bank would have to use judicial process to attach a cardholder's deposit account before it could debit the account to satisfy his credit card debt. Under *Fuentes* and its progeny, attachment would undoubtedly invoke due process notice and hearing requirements.[129]

Nevertheless, the flexibility and convenience of existing bank credit card plans would be preserved. Pursuant to section 169, a cardholder desiring to avoid making monthly payments could give his bank written authorization to charge his credit card debt against his deposit account on a regular basis. Even in this situation the cardholder is protected because he retains the right to revoke his authorization with respect to disputed amounts.[130] Furthermore, it seems unlikely that banks would be allowed to include an authorization clause as a mandatory provision in all cardholder agreements. The remedial nature of the Truth in Lending Act would be inconsistent with judicial enforcement of purported authorization clauses executed as part of an adhesion agreement or obtained in a manner not calculated to invoke knowing consent by the consumer.

As this note is written, the bill amending the Truth in Lending Act is being considered by the House Banking and Currency Committee after passing the Senate on July 23, 1973, by a

128. As written, this section is broad enough that it could be interpreted to override the provision of the Bankruptcy Act, 11 U.S.C. § 108 (1970), which allows the setoff of mutual debts between the estate of a bankrupt and a creditor. The Bankruptcy Act at present clearly allows a bank to set off a bankrupt's deposit account against any debts owed by him to the bank, absent fraud or collusion. Farmers Bank v. Julian, 383 F.2d 314, 324 (8th Cir.), *cert. denied*, 389 U.S. 1021 (1967). There would seem to be no reason for the Truth in Lending Act to change a rule affecting only the priorities of creditors, and such a result is probably not intended by the proposal. The caveat of subsection (b) could easily be expanded to make it clear that the Bankruptcy Act provision is not to be affected.

129. *See* notes 49-59 and accompanying text *supra*.

130. The details of this right of revocation and how the consumer is to be informed of it would be left to implementing regulations of the Federal Reserve Board. S. REP. No. 93-278, 93d Cong., 1st Sess. 9 (1973).

vote of 90-0.[131] A similar bill,[132] however, was passed by the Senate during the Ninety-Second Congress only to die in the House Banking and Currency Committee.[133] Senator Proxmire, the principal sponsor of both bills, has evinced the fear that the same result may await the current proposal.[134] Thus the prospects for an immediate legislative resolution of the problem remain uncertain.

V. CONCLUSION

It appears from the preceding discussion that summary banking setoff of a customer's bank credit card debt against his deposit account is virtually unregulated by present law: The practice comports with all the traditional common law prerequisites for setoff; it is not violative of due process for it entails no state action; and it is not controlled by existing consumer legislation because of its unique status as an equitable remedy growing out of the debtor-creditor relationship. A court, of course, could conceivably reach a contrary result because these questions assuredly turn on fine distinctions. In the interest of logically consistent legal theory, however, it would be better to encourage legislative resolution of the issue than to stretch and distort existing judicial doctrines.

In weighing the alternative responses that a legislature could adopt, the determinative question should be what abuses and inequities exist and how they could best be eliminated. It is possible to formulate fact situations in which bank credit card setoff would lead to totally unjust results. Assume, for example, that a bank's billing department has charged a customer twice for a credit card purchase, that the customer has been unable to penetrate the bank's bureaucracy to have his account corrected, and that the automatic warnings of the computerized billing system have run their course.[135] If the bank exercises its setoff power and collects the stated amount due, the customer may decide that it is not worth the trouble to pursue the matter further, especially

131. 119 CONG. REC. 14,428 (daily ed. July 23, 1973).

132. S. 652, 92d Cong., 1st Sess. (1971).

133. *See* S. REP. No. 93-278, *supra* note 130, at 29 (additional views of Messrs. Proxmire and Hathaway).

134. *Id.*

135. Experiences of this type are reported by numerous witnesses in *Hearings on S. 652*, *supra* note 10.

if the amount n dispute is relatively small. Or, if the customer is uneducated and inexperienced in such matters, he may simply be so overwhelmed by this type of summary action that he has no idea how to seek appropriate relief.[136] In either event, the bank has profited by its own mistake and the customer has been unfairly deprived of his funds by the bank's exercise of its setoff power.

The proposed Proxmire amendment to the Truth in Lending Act[137] would eliminate abuses of this type by denying the setoff power to banks in their credit card operations. The efficacy of this solution is hardly open to question, but the necessity for it is not so clear. The necessity could be shown by documentation of a significant number of cases, such as the one described above, in which consumers are being treated inequitably.[138] In the absence of such documentation,[139] however, it would seem only fair to assume that the banks are using setoff more judiciously. The question thus becomes whether bank credit card setoff should be prohibited even though it has only been used to collect delinquent debts from cardholders who can make no claim of inequity. Although it is possible to argue that setoff should be prohibited even in this situation, there seems to be no reason to abolish a practice which has not been proved unfair. In the absence of

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136. The Supreme Court in *Fuentes* recognized the existence of this problem. The Court exhibited concern about the efficacy of protective provisions requiring a party seeking the writ of replevin to post bond and expose himself to possible liability for damages. Concluding that these limitations would at most test the strength of the applicant's own belief in his rights, the Court stated:

> They may not even test that much. For if an applicant for the writ knows that he is dealing with an uneducated, uninformed consumer with little access to legal help and little familiarity with legal procedures, there may be a substantial possibility that a summary seizure of property—however unwarranted—may go unchallenged and the applicant may feel that he can act with impunity.

407 U.S. at 83 n.13.

The likelihood of this consumer reaction seems even greater in banking setoff than in replevin. First, setoff is a self-help remedy which does not even require that a bond be posted. Second, the consumer is even less likely to recognize a bookkeeping manipulation as an infringement subject to legal redress than he is to recognize a physical seizure of his tangible property under replevin.

137. *See* note 127 and accompanying text *supra*.

138. Discovery of those cases in which the consumer silently accepted his fate would be unlikely, but at least some of the victims could be expected to be both loud and industrious in exposing their experiences.

139. The authors in their research did not find a single documented example of this type of abuse, or even an unsupported allegation that such abuses occur. In particular, no such allegations were made in the Senate hearings on the 1971 Proxmire legislation. *Hearings on S. 652*, *supra* note 10.

further evidence, the Proximire proposal on this particular point may be an overreaction.

The legislative response that does seem appropriate is to make meaningful disclosure of the setoff power mandatory under the Truth in Lending Act. An undisclosed right of this sort in a consumer credit agreement is directly contrary to the stated purpose of the Act.[140] Knowledge of the existence of the setoff power might significantly influence a customer's decision to enter a credit card agreement with the bank handling his deposit accounts, or vice versa. Why should a bank benefit from the happenstance that one of its cardholders is also a depositor,[141] when the customer has never been made aware of the consequences of his dual role? The failure of the Truth in Lending Act to preclude such uninformed decision-making by the consumer was probably no more than an oversight. A mandatory requirement of meaningful disclosure would be consistent both with existing provisions of the Truth in Lending Act and with the demonstrated nature of the setoff practice.

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140. The purpose of the Truth in Lending Act is "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit." 15 U.S.C. § 1601 (1970).

141. It is actually more than happenstance because, during the period of mass unsolicited mailings of bank credit cards, lists of bank depositors were a prime source of names. Weistart, *supra* note 3, at 1480 n.13; *Hearings on S. 652, supra* note 10, at 236 (statement of Prof. William F. Willier).