

LEGAL AND INSTITUTIONAL METHODS
APPLIED TO THE DEBITING OF DIRECT
DISCOUNTS—I. LEGAL METHOD:
BANKER'S SET-OFF

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THIS article is the first of a series addressed to the problem: What is the effect of the arrival of the maturity day of the customer's time note which had been discounted for him by his bank and credited to his account upon the bank's obligation to him to honor his checks? In this context the problem calls for an answer which is a statement of law. "Statement of law" might be used to refer to norms to which it is believed judges should conform or to existing rules with which they must comply. It might be used to refer to a description of the judicial decisions of the past or to forecasts of judicial decisions in the future. Such forecasts might be intuitional judgments of particular situations against the background of unanalyzed experience or they might be the result of the application of the traditional method of lawyers. In this article "statement of law" is used to refer to forecasts which are the result of the application of legal method. This method is to circumscribe upon the web of experience a very large number of complexes of events each one of which includes, among many other things, the "facts" in a litigation and the decision. From the bewilderingly numerous constituents common to all the complexes the "facts" and the decision are isolated for study. The "facts" are very roughly grouped on the basis of similarity. If more often than not somewhat like "facts" are accompanied by somewhat like decisions, generalizations are first ventured and then pyramided into a system. In the course of this process there appear the concepts of promise, consideration, bargain, implied-in-fact promise, contract, quasi-contract, tort, etc. Unfortunately the categories are very wide and loose. Consequently, legal method is crude and its forecasts uncertain. Nevertheless it is the only method lawyers have at their disposal. All of them regularly employ it even when they pretend to rely wholly upon intuition. Legal method is applied in this article. In the subsequent articles the problem will be reinterpreted and in its new guise faced again.

The problem is presented by the cases of *Callahan v. Bank of*

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Anderson,¹ *Delano v. Equitable Trust Co.*² and *Goldstein v. Jefferson Title & Trust Co.*³ The facts of each are taken to be those stated in the official reports. In the first it was held that a commercial bank's obligation to its checking account customer was not reduced by the amount of a promissory note made by the customer to the bank and discounted by it, though the note was long past due, in the absence of notice that the bank had debited the note to his account. In an action brought by the customer for the dishonor of a check presented by a third person, a demurrer to the bank's answer setting up the maturity of the note as a defense was overruled. In the second case, again an action by the drawer for dishonor of a check presented by a third person, the reply having admitted the allegations of the answer that the defendant held an overdue note which had been discounted for him, the defendant's motion for judgment on the pleadings was granted. It was ruled that the maturity of the note reduced or at least gave the bank a power to reduce its obligation by the amount of the note even in the absence of notice to the customer that his account had been debited. In the third case, an action by the drawer for dishonor of a check presented by a third person on the morning of the day of maturity, facts similar to those pleaded in the *Callaham* and *Delano* cases appearing by uncontradicted evidence, a judgment for the defendant was granted on a motion *non obstante veredicto*. The court formulated a rule like that stated in the *Delano* case. The view taken by the New York and Pennsylvania courts and the dissent in the *Callaham* case is well stated in the following language appearing in the dissenting opinion:

"It is undoubtedly the general rule that a bank is bound to honor the check of its depositor if it has sufficient funds of the depositor to pay the check when presented, because of the implied agreement to do so, arising from the relation of the parties. The ordinary relations between the depositor and the bank is that of creditor and debtor, respectively, to the extent of the deposit, and while the relation so stands, the rule broadly stated above applies; but if, when a check is presented, the relation is altered, and the depositor is debtor to the bank on some material obligation upon which the bank would have a right of action against the depositor, then manifestly it is just that the bank should be allowed the right to set off the past due indebtedness of the depositor against its liability on the general deposit, as if the depositor were then suing the bank on account of the deposit. To hold otherwise would be to deny to a bank the same right of set-off accorded to all other persons between whom there exists mutual demands. This right of the bank with respect to general de-

¹ 69 S. C. 374, 48 S. E. 293 (1904) (lower court decision allowed to stand as upper court evenly divided).

² 110 Misc. 704, 181 N. Y. Supp. 852. (Sup. Ct. 1920).

³ 95 Pa. Super. Ct. 167 (1928).

posits, which is sometimes called a lien, is more accurately the right of set off, for it rests upon, and is co-extensive with, the right to set off as to mutual demands."⁴

It will be observed that in none of these cases was the matured note pleaded by way of set-off or counterclaim. Had it been it would be clear that the note would serve merely to reduce the amount of the plaintiff's recovery and would not necessarily preclude a recovery. The rules for the measure of damage in an action for dishonor permit the recovery of the amount of the check⁵ with interest,⁶ consequential damages in contemplation of the parties,⁷ and damages for the injury resulting to the plaintiff's credit arising from the knowledge of third persons that his demands upon his banker have been refused⁸—a sum which

⁴ 69 S. C. at 381, 48 S. E. at 295. *Cf.* Delano v. Equitable Trust Co., *supra* note 2, at 705, 707, 181 N. Y. Supp. at 853, 854: "The relation of banker and depositor creates the relation of debtor and creditor. The depositor's money is taken by the bank in the nature of a gratuitous loan, and thereupon the bank charges itself with a debt absolutely due to the depositor. And this is so though the bank were to lose the money without fault. Where a depositor is indebted to his bank there exists a mutual indebtedness, and the right of setoff applies. Both the banker and depositor hold as debtors the moneys of their creditors, and the right of either to make application to the debt of the credit is determinable by the ordinary rules of law relating to the right of setoff. Such rules of law between a bank and its depositor are the same as those applicable to other parties.

. . . In no case in this state to which my attention has been called has it been decided that the right of setoff by a bank can only be exercised after notice. The well understood and generally accepted relations existing between banker and depositor neither as matter of law or custom call upon the bank to notify the depositor that his account has reached or is about to reach such a state as to require replenishing before he attempts to further draw against it. And the ordinary obligations existing between debtor and creditor do not demand notice to the maker of a note that the same is due. The debtor knows, or should know, what he owes and when it is payable." Compare the similar statement in Goldstein v. Jefferson Title & Trust Co., *supra* note 3, at 169.

⁵ Chicago Marine & Fire Insurance Co. v. Stanford, 28 Ill. 168 (1862); Levine v. State Bank, 80 Misc. 524, 141 N. Y. Supp. 596 (1st Dep't 1913); Winkler v. Citizens State Bank of Geuda Springs, 89 Kan. 279, 131 Pac. 597 (1913).

⁶ Winkler v. Citizens State Bank of Geuda Springs, *supra* note 5; 17 C. J. 818; ENG. CIV. PROC. ACT, 3 & 4 WM. IV, c. 42, § 28 (1833); ILL. REV. STAT. (Cahill, 1927) c. 74, § 2.

⁷ Kleopfer v. First National Bank, 65 Kan. 774, 70 Pac. 880 (1902).

⁸ *Dishonor because of error in computing balance*: DeLaunay v. Union National Bank, 116 S. C. 215, 107 S. E. 925 (1921); Dyson v. Union Bank of Australia, Ltd., 8 Vict. L. R. 106 (1882); McFall v. First National Bank of Forrest City, 138 Ark. 370, 211 S. W. 919 (1919); First National Bank of Forrest City v. McFall & Co., 144 Ark. 149, 222 S. W. 40 (1920); Schaffner v. Ehrman, 139 Ill. 109, 670, 28 N. E. 917 (1891); Siminoff v. Goodman & Co. Bank, 18 Cal. App. 5, 121 Pac. 939 (1912); Spiegel v.

may be in excess of the amount of the note even though the check be for a less sum.

It will also be observed that the courts in the last two cases justify their conclusion that the note gives rise to a defense on the ground that a banker's set-off is a defense. But why a banker's set-off should be a defense while the set-offs of other persons are not is not indicated.

It may be that those who speak of banker's set-off have in mind a rule that the amount of the bank's obligation equals the balance of the current account, *i.e.*, the difference between the sum of the payments by customer to bank and the sum of payments by bank to customer, and that they are assuming that the proceeds of the discount of the note though paid against checks are not an item on the credit side of the current account. If this were true, it is clear that the customer would not be obligated to pay the amount of the note but that his obligation would be measured by the debit balance.

It may be that those who say that a banker's set-off is a defense are led to do so by the fact that in many actions by a customer the only damages sought are the amount of the dishonored order. Indeed in all of the cases in which a banker's set-off is said to have this peculiar effect, except those to which this article is addressed, the customer was claiming no more than his "balance;" in some the note was pleaded as a set-off, and in others it is impossible to determine from the report whether the customer's overdue note was pleaded as a set-off or defense.⁹ That the suggested explanation accounts for the decision in the only case of this type in which the report shows the distinction between a set-off and a defense was urged upon the court is strongly suggested by the brevity of the court's only observation upon the point:

"It is not necessary to file a plea of set-off, to make this defense. The pleas filed were sufficient for that purpose. One of the pleas was to the effect that the defendant bank was never indebted to the plaintiff as alleged. Other pleas were to the effect that the

Public National Bank of New York, 184 N. Y. Supp. 1 (Sup. Ct. 1920); *Weiner v. North Penn Bank, Inc.*, 65 Pa. Super Ct. 290 (1916). *Dishonor for reason other than mistake (bank bona fide)*: *American National Bank v. Morey*, 113 Ky. 857, 69 S. W. 759 (1902); *Bank of Commerce v. Goos*, 39 Neb. 437, 58 N. W. 84 (1894); *First National Bank of Hutchinson v. Kansas Grain Co.*, 60 Kan. 30, 55 Pac. 277 (1898); *Meinhart v. Farmers State Bank*, 124 Kan. 333, 259 Pac. 698 (1927); *Rolin v. Steward, Public Officer of the East of England Bank*, 14 C. B. 595 (1894); *Westeson v. Olathe State Bank*, 75 Colo. 340, 225 Pac. 837 (1924); 78 Colo. 217, 240 Pac. 689 (1925); *Wildenberger v. Ridgewood National Bank*, 230 N. Y. 425, 130 N. E. 600 (1921). *Dishonor for reason other than mistake (ill will)*: *Commercial National Bank v. Latham*, 29 Okla. 88, 116 Pac. 197 (1911) (sight draft).

⁹ 7 C. J. 653, n.84.

defendant bank did not have in its possession the sum of \$28,059.37, or any sum, deposited with it by Mason Young as receiver. These pleas were sustained by the findings of the court. When it was shown that the bank held Young's notes as receiver for an amount which equalled the deposits, and that the deposits had been applied to the payment of these notes, a good defense was proved under these pleas."¹⁰

In such cases it is obvious that the plaintiff's obligation on the note even if pleaded by way of set-off would prevent a recovery by the plaintiff. The distinction between such a case and one in which the plaintiff is entitled to damages beyond the amount of his dishonored order has been overlooked. Consequently it has become common to speak of a banker's set-off for the amount of the note as a defense.¹¹

To be sure, calling the customer's note a defense because it gives rise to a banker's lien or banker's set-off suggests that there is something peculiar in the relation of bank and customer which justifies this surprising metamorphosis of a set-off into a defense. But certainly the problem raised by the principal cases is not resolved, but simply restated, by reference to banker's set-off.

Before proceeding to the detailed analysis of the relation between bank and customer which the solution of the problem requires, certain propositions which are assumed should be made explicit. There are two classes of transactions between a commercial bank and a checking account customer as a result of which the bank comes under an obligation to make transfers ("payments" of one of the media of exchange) in the future: (1) those in which the bank promises to make transfers in exchange for transfers presently made by the customer and (2) those in which it promises to make transfers in exchange for the customer's promises to it. These two types of transactions, however, result in but one obligation. This obligation endures as long as the bank's promises of either type continue to call for performance. The amount of the bank's obligation equals the sum of the amounts of the bank's promises which continue to call for performance, both those given in exchange for transfers to it and those given in exchange for promises to it.

These assumptions are implicit in the method employed in the United States in writing up a customer's account in the bank's individual ledger. Both loans and deposits are entered as credits. Both matured loans and withdrawals are entered as debits. The credit balance indicates the amount of the bank's obligation.¹²

¹⁰ *Durkee v. National Bank of Florida*, 102 Fed. 845, 849 (C. C. A. 5th, 1900).

¹¹ *Supra* note 9.

¹² *KNIFFIN, COMMERCIAL BANKING* (1923) 491, 599, 605, 761; *DAVIS, BANK ORGANIZATION, MANAGEMENT AND ACCOUNTS* (1910) 94, 104-105.

It should be observed, however, that this method of writing up the individual ledger combines disparate transactions and refers to both by identical symbols. The ledger account includes transactions which are and others which are not items in the current account. The current account is a series of transactions each one of which is a transfer of the medium of exchange either by the customer to the bank or by the bank to or for the customer. Thus, of the transactions described above, only those of the first class are included in the transactions which go to make up the current account. But the current account also includes transfers made by the bank in performance of its promises of either class. Thus the balance of the current account shows the difference in the amount of the actual transfers. It is not necessarily a measure of the obligation to pay. If there were no transactions of the second class the balance would be the vector of the obligation to pay, indicating its direction and measuring its amount.¹³

I. PROMISES BY A BANK GIVEN IN EXCHANGE FOR TRANSFERS

How methods of bank bookkeeping hide the fact that banks receive both transfers and promises to transfer has been noticed. In addition and more important, the difference between transfers to the bank of the media of exchange (deposit currency, federal reserve notes, national bank notes, gold certificates, silver certificates, treasury notes, greenbacks, gold, silver and subsidiary coin) and transactions in which the bank receives credit instruments (notes made by customers, notes made by third persons, and bills, accepted and unaccepted) is obscured.

The preference of lawyers for wide categories makes for the same obscurity. Like the bookkeepers they too group the receipts of a bank from its customers in order that they will not have to differentiate the legal consequences of a discount from the legal consequences of a deposit of the media of exchange. Thus they say that when a note is discounted it is as if the bank had given the customer the proceeds of the discounted note in cash and as if the customer thereupon had deposited them.¹⁴ Sometimes the grouping is justified by a subtler analysis. Thus in a recent legal article it is said, "If a promissory note payable to a solvent commercial bank . . . were discounted for the maker by the bank and the price though due were not demanded by the maker, the financial and legal consequences would be those of a demand loan by maker to bank. If bullion, coins, bank notes, or deposit currency were sold . . . to a bank and the price not

¹³ LANGDELL, *A BRIEF SURVEY OF EQUITY JURISDICTION* (2d ed. 1908) 114-115; Moore and Shamos, *Interest on the Balance of Checking Accounts* (1927) 27 *COL. L. REV.* 633-634.

¹⁴ *E.g.*, *Hennessy Bros. v. Memphis Bank*, 129 Fed. 557, 559 (C. C. A. 6th, 1904).

demand when due, the consequences would be those of a demand loan."¹⁵ On a subsequent page the authors say that the discounting of a note is an item of the current account because the failure of the customer to make immediate demand for the proceeds is in effect a transfer of the medium of exchange to the bank.¹⁶

The difference, however, between transfers and promises to transfer is obvious. No one, for example, would fail to observe the difference of a transaction in which he exchanged a thousand dollar bill for a twenty-year bond from a transaction in which he exchanged a thousand dollar bill for ten one hundred dollar bills. The distinction is made as a matter of course by bankers and accountants when they list the media of exchange and the obligations of customers as separate items in the financial statement of a bank. And the distinction may well be of importance.

It will be recalled that the assumption was made that in the transactions in which the bank received transfers of the media of exchange from the customer it promised to make transfers. What are the terms of the promise? The promise of the bank, whatever its terms may be, must be a promise which is implied in fact; express promises are not made. If there were no current account between bank and customer, the process of constructing the promise would be to take account of the fact that a bank is engaged not only in receiving but also in paying out the medium of exchange and that it relies, though not exclusively, on its receipts for the medium which it needs in its paying operations. In order that the medium which it receives may be available to effect its paying operations, the medium must be received to its use, as its own, and not as bailee or fiduciary. Where there is a shift of the ownership of the medium from one to another the promise which it is to be inferred the transferee makes is to transfer to the use of the transferor something equivalent in value.¹⁷ And where, as here, the transaction is in a community where exchanges are effected by means of money, the promise is to pay an equivalent in money to the use of the payee. The exact equivalent would be a perpetual series of interest payments at the current rate of interest.¹⁸ Approximate equivalents are payment of an equal sum in the future with interest in the meantime, and payment of an equal sum on demand. Though payment of an equal sum on demand may not be an exact equivalent in constructing the promise it is chosen because a promise to pay such an equivalent, in view of the fact that exchange is almost exclusively effected by deposit currency, puts

¹⁵ Moore and Shamos, *op. cit.* *supra* note 13, at 633.

¹⁶ *Ibid.* 646.

¹⁷ The transaction is a loan. *Ibid.* 633.

¹⁸ FISHER, THE NATURE OF CAPITAL AND INCOME (1906) 191-195, 202.

the transferor in a position most nearly like the one he surrendered by making the payment. The reasons for the choice of this equivalent have been elsewhere stated as follows:

"The principal motive of the customer who obtains the promise of a bank to honor his checks and opens and maintains a current account by the balance of which is to be gauged the bank's liability under its promise, is to secure a supply of the common medium of exchange, i.e., deposit currency in the checking account form. This the customer has secured the moment the bank's promise is made and a sufficient balance established. The bank's promise is the medium of exchange. The performance of that promise by crediting the checking account of the payee named in the customer's check, or by crediting the checking account of a collecting bank employed by the payee, or by giving its own check on its correspondent, is commonly thought of not as a performance of a promise, but as a step in the transfer of the medium of exchange. To the parties the transaction which takes place whenever the customer make an advance on the checking account appears as a purchase rather than a loan. Partly for this reason, the vast majority in number of checking accounts are not accompanied by a bargain for the payment of interest by the bank. On the contrary, the time deposit and the current account of the commercial bank with a customer whose checks it has not promised to honor, e.g., the "savings" account, are usually accompanied by a promise to pay interest. These are bargains in which the customer is seeking investment. Furthermore they are made with a view to payment or liquidation in the future; and in these two important respects they differ from the bargain for the operation of a checking account."¹⁹

As a result of these considerations the implied-in-fact promise would be found to be one which by its terms will continue to call for performance until the promisor actually pays or transfers of the medium of exchange are made. Such a promise would be recognized as part of a unilateral bargain which imposes a debt obligation upon the promisor.²⁰

The fact that the transfer of the medium to the bank, however, is a transfer which is only one in a series of similar transactions between the commercial bank and its customer constituting the current account must be considered in implying the promise. The effect of the current account upon the promise implied-in-fact is aptly described by Langdell:

"An agreement between two parties to set off cross demands against each other may, however, relate to cross demands not then existing, but thereafter to arise; and in that case it seems that the agreement will operate upon the cross demands and cause their mutual extinguishment the moment they arise, provided neither of the parties have given any notice to the other to

¹⁹ Moore and Shamos, *op. cit. supra* note 13, at 636.

²⁰ LANGDELL, *op. cit. supra* note 13, at 115.

the contrary; for, in the absence of such notice, the parties will be conclusively presumed to remain of the same mind they were of when the agreement was made, and therefore the effect will be the same as if the agreement had been made at the moment when the cross demands arose. It is as true, however, of such an agreement as it is of an agreement to set off existing cross demands, that it will seldom be made otherwise than by implication; and the implication in this latter case will generally arise, if at all, from the nature and the course of the dealing between the parties. Moreover, the agreement will arise the moment it is called for by circumstances, *i.e.*, the moment that cross demands come into existence, and not till then; and as often as new cross demands arise, a new agreement to set them off against each other will arise. The cross demands, therefore, and the agreement to set them off against each other, will always co-exist, and hence there can be no doubt that the agreement will operate upon the cross demands and cause their actual extinguishment. . . .

It is, it seems, on the principle just explained, that cross demands between a banker and his customer extinguish each other. Indeed, if there be cross demands between a banker and his customer, there can be no doubt that they extinguish each other, and they can do this only in the mode just explained or by operation of law."²¹

The promise of the bank can now be stated. In anticipation of a series of mutual transfers of which the number, amount, and date cannot be foreseen, the commercial bank and the prospective customer come to the understanding that if nothing to the contrary be agreed at the time of each transfer by the customer to the bank the receipt of each transfer shall indicate that the bank bargains to pay to the customer upon demand the difference between the sum of the transfers by the customer and the sum of the transfers by the bank if the difference is in favor of the customer.²²

II. PROMISES BY THE BANK GIVEN IN EXCHANGE FOR PROMISES

In addition to transactions in which the bank receives medium of exchange there are others in which the bank receives credit instruments to which the customer is a party. These credit instruments are instruments upon which the customer is the primary party and instruments upon which a third person is the primary party and which are eventually paid by the third party. The last class includes those which are drawn by or on a bank and are paid by the bank upon which drawn and those drawn by or on other persons. The credit instruments in which we are interested are promissory notes made by the customer payable to the bank. It will be recalled that in the principal cases the

²¹ *Ibid.* 114.

²² Moore and Shamos, *op. cit. supra* note 13, at 633-634.

note was a matured time note. The discussion therefore will be directed to time rather than to demand notes.

What is the bank's promise where it receives the promissory note of a customer? Here again, as in the case of a deposit of the medium of exchange, the bank's promise must be found as there is no express promise.

One of the sources from which a bank obtains the medium of exchange necessary for the conduct of its business is the sale of securities in which it has invested and upon which it can realize immediately in the open market. In order that a bank may be free to sell its investments the bank must own them. A bank usually pays for its investments when it acquires them and in the rare case where it does not, the promise implied-in-fact is one to pay something equivalent in value, which in this case is a sum equal to the current or market price of the credit instruments purchased.²³

The customer's promissory note is a credit instrument in form like those representing the long and short term investments which the bank purchases.²⁴ But the promissory note of a customer is seldom sold²⁵ and indeed often is not salable in the open market. A bank may occasionally use its customer's note to raise money at its correspondent or at a Federal reserve bank. Generally it does not.²⁶ The fact that a bank rarely sells the note whereas it usually sells investments indicates that a bank need not acquire the ownership of the note. The note and the investment are employed for different ends. The similarity in form is misleading. Therefore the bargain in which the bank acquires the note may well be different. It cannot be implied in fact as in the bargains in which investment securities are acquired that a bank when acquiring its customer's note is making a promise to buy it.

But customers' promissory notes are sometimes used by the bank as collateral. That of itself does not indicate that the bank has bought the credit instruments. One who admittedly holds a credit instrument as collateral security may and often does assign the collateral with the obligation it secures as collateral for a loan to him.²⁷

²³ AGGER, ORGANIZED BANKING (1918) 43, 48-51, 147; DUNBAR, THE THEORY AND HISTORY OF BANKING (5th ed. 1929) 30, 36-37.

²⁴ Aigler, *Recognition of New Types of Negotiable Instruments* (1924)
²⁴ COL. L. REV. 580-584; Crittenden v. Widrevitz, 272 Fed. 871 (C. C. A. 2d, 1921); Murray v. Wagner, 277 Fed. 32 (C. C. A. 2d, 1921); Crum v. Hanna, 140 Va. 366, 125 S. E. 219 (1924); Dengler v. Paul, 83 Pa. Super. Ct. 37 (1924); Pratt v. Higginson, 230 Mass. 256, 119 N. E. 661 (1918); Utah State National Bank v. Smith, 180 Cal. 1, 179 Pac. 160 (1919).

²⁵ AGGER, *op. cit. supra* note 23, at 146, 151-152.

²⁶ *Ibid.* 151-152, 283, 285-286; DUNBAR, *op. cit. supra* note 23, at 291-292.

²⁷ Coleman v. Anderson, 82 S. W. 1057 (Tex. Civ. App. 1904), *aff'd*, 98

Again, though a bank may ultimately by means of payment realize in the regular course of business the amount of notes discounted for its customers and though it relies on such realization for the necessary medium, this does not justify implying a promise such as that given by the bank when it buys investments. On the contrary, this course of business shows the striking similarity of a bank to a professional lender who in fact realizes upon his loans in the same way and who, like the bank, also looks to liquidation to supply him with the means to further operations. Were repayment by the borrower the only way the lender could realize on his loans he would not be said to have "purchased" his borrower's promise to pay. That promise would appear not as the bargain equivalent or consideration for the money borrowed but rather as "collateral security" the redemption of which would be accomplished by the act of payment. In the same way it might be said that the bank which realizes by repayment on credit instruments discounted for its customers has made loans to them and has taken their credit instruments as "collateral" only.²⁸

The fact that the supposed lender could sell the promise would not require any change in the conclusion reached unless it also appeared that he had acquired it for purposes of sale. Where this does not appear a subsequent sale would simply indicate that he might have purchased. But even admitting that a subsequent sale indicates a purchase, whether a purchase is to be implied in any particular case would depend upon whether in the usual course of business he sells such promises. For these reasons it seems that neither a purchase by the lender nor a purchase of a customer's credit instrument by a bank would be implied.

The conclusion is that the receipt by the bank of the customer's note is not sufficiently like a purchase of an investment to find a promise on the bank's part to pay the face of the note (less the discount, if any) as the "price"—to find a promise which would result in a debt obligation. On the contrary, it appears that the transaction is more like a bargain to make a loan in which the credit instrument has been delivered but the lender's promise has not yet been performed.

In such a bargain is the lender's promise to make the transfer one which remains in force until performed, or is it a promise which by its terms expires upon the failure of the borrower

Tex. 570, 86 S. W. 730 (1905); *Waddle v. Owen*, 43 Neb. 489, 61 N. W. 731 (1895).

²⁸ Indeed, this is the assumption made in applying usury statutes to the discount by a bank of its customer's note. *International Bank of Coalgate v. Mullen & Mullen*, 30 Okla. 547, 120 Pac. 257 (1911); *Bank of the United States v. Owens*, 2 Pet. 527 (U. S. 1829).

to request the transfer within a limited period? Certainly it might be either. Regarding the note transaction as analogous to an agreement for a loan, what should be implied as to the period during which the bank's promise assures the customer it will honor his orders? The note contains the express promise of the customer to pay at a future day—a promise not conditional upon the bank's honoring his orders. Such promise is in a form calculated to obligate the customer to pay the note whether or not the transfer has been made by the bank. In exchange for such a promise, a promise by the bank unlimited in point of time and not conditional upon payment of the note might be implied. A bilateral bargain with independent promises would be the result. If the customer failed to pay the note, the dishonor of his check drawn and presented after maturity would give him an action for damages. Of course a recovery might in effect be prevented or at least the amount of the recovery reduced by a counterclaim for the amount of the note. If the bank had refused to make the promised transfer by dishonoring the customer's check, it would, at maturity, have an action against the customer as maker for the amount of the note; but its action would be met by a counterclaim for a sum at least equal to and perhaps more than that amount. One might be compelled in such a situation to acquiesce in attaching such fundamentally inconsistent and practically clumsy legal consequences to a bargain compounded of specially formulated express promises expressly independent. But when they result from a bargain comprising a purely formal promise in a negotiable instrument on the one hand and a promise wholly implied-in-fact on the other, one is led to believe that he has not been successful in his efforts to ascertain the bargain of the parties.

If no transfers of the medium had been requested by the customer, there would have been no default upon the part of the bank, for the bank's obligation to make transfers is conditional upon an actual presentation of an order and demand.²⁹ Therefore it seems the customer would have no set-off. Yet in an action on the note, the bank may not recover as it is said the customer has a set-off.³⁰ It is absurd to call such a defense a set-off. But it would be equally absurd to permit the bank to recover only to become in turn an obligor to the customer in the same amount.

But suppose a promise by the bank unlimited in point of time

²⁹ *Brahm v. Adkins*, 77 Ill. 263 (1875); *Downes v. Phoenix Bank of Charlestown*, 6 Hill 297 (N. Y. 1844); *Tobias v. Josiah Morris & Co.*, 126 Ala. 535, 28 So. 517 (1900); *N. Joachimson v. Swiss Bank*, [1921] 3 K. B. 110.

³⁰ *Puget Sound State Bank v. Washington Paving Co.*, 94 Wash. 504, 162 Pac. 870 (1917).

but conditional upon payment of the note were found. Then after the customer's default upon the note, the dishonor of his check drawn and presented after maturity would not give him an action against the bank. Nevertheless since the promise contained in the note is unconditional, the bank notwithstanding its default would have an action against him. The satisfaction of the bank's judgment would, it seems, place the bank under an obligation to honor his checks thereafter drawn and presented. This surprising result might be avoided by depriving the bank of its claim on the note because of the circuitry of action its enforcement would entail. But it appears even more surprising to imply in fact a bargain the enforcement of which is refused because of the absurdity of enforcing it according to its terms.

If it be supposed that the promise of the customer is that contained in the note but that the promise of the bank is to make transfers if demanded within a limited period only, the result would be even more surprising. If the customer made no demands within the period, the bank would recover upon the note and the customer not only would have neither a set-off or counterclaim nor a defense but also would never thereafter by demands be able to subject the bank to a duty to pay.

It appears, therefore, that by taking the credit instrument to state the customer's side of the bargain a sensible bargain cannot be constructed. Whether the implied-in-fact promise of the bank be assumed to be unlimited or limited in point of time, unconditional or conditional, the bargain and the legal consequences conforming to its terms would be absurd.

It is necessary, therefore, to look for the customer's promise outside the promissory note. Both sides of the bargain must be implied in fact. The bargain was made against the background of a current account between the parties. Like all transfers between bank and customer, the transfers to the customer in pursuance of the note transaction are, in the absence of contrary agreements, debit items in that account.³¹ This is as true of the transfer to the customer of the face amount of the note in one sum at the time of discount as of any other transfer, and the circumstance that the transfer follows immediately upon the discount does not indicate an agreement that the transfer shall not be a debit.³² It follows that the debit balance of the account will include the transfers received as a result of the note transaction. And by virtue of the fact that the transfers to the customer are upon his order or request and that they are controlled by the understanding underlying the current account, there is an implied-in-fact promise of the customer to make trans-

³¹ LANGDELL, *op. cit. supra* note 13, at 114-115; Moore and Shamos, *op. cit. supra* note 13, at 633-634.

³² See *Cumming v. Shand*, 29 L. J. Ex. (N. S.) 129 (1860).

fers to the bank in an amount equal to that by which its transfers exceed his. This promise and its consequent obligation obviously include the amounts transferred as a result of the note transaction. Consequently were it not for the matters of time of reimbursement and interest there would be no reason for supposing that the agreement implied-in-fact from the note transaction included any promise whatever on the part of the customer. But a debit balance of the current account ordinarily must be met forthwith by transfers from the customer.³³ And if, then, there were no agreement as to time of reimbursement the obligation of the customer consequent upon the transfer in pursuance of the note transaction would be due forthwith. Interest, were there no agreement, would certainly be restricted to the amount actually transferred by the bank under the note transaction; perhaps would not be allowed at all except as damages and if it were, might be at a rate different from the customary or market rate.³⁴ It must be supposed, therefore, that the bargain implicit in the note transaction was one in which there was a promise by the customer to reimburse the bank in an amount equal to the debit balance on the day upon which the note matures and to pay the interest stipulated therein. As to the other terms of this promise what reason is there for supposing them to be any different from those implied in the case of transfers by the bank which are not in pursuance of a note transaction, but nevertheless result in an extension of credit, as in the case of unagreed-to-overdrafts? There is none, for there are present in both situations the same parties, the same background, and in both credit extensions are effectuated by the honoring of checks without any express promise by the customer at the time of the payment or transfer.

That this is the promise affords the most rational explanation of the decision in *Puget Sound State Bank v. Washington Paving Company*.³⁵ There the complaint was in form for a recovery upon the note which had matured. Though it appeared that the customer had not, by check or otherwise, demanded the credit balance as shown in the individual ledger account (in which there appeared a "credit entry" for the amount of the note) he was permitted to counterclaim for the balance. Assuming that the bank was obligated to make transfers up to the amount of such credit balance only after actual demand, it had not de-

³³ *Bank of Statesville v. Waddell*, 100 N. C. 338, 6 S. E. 414 (1888); *Earle v. Munce*, 133 Fed. 1008 (C. C. E. D. Pa. 1904); *Hennessy Bros. v. Memphis Bank*, 129 Fed. 557 (C. C. A. 6th, 1904); *Lyon County Bank v. Schaefer*, 102 Kan. 868, 171 Pac. 1159 (1918).

³⁴ *Moore and Shamos*, *op. cit. supra* note 13, at 648.

³⁵ 94 Wash. 504, 162 Pac. 870 (1917).

faulted.³⁶ Therefore it seems impossible to sustain the decision reducing the amount of the recovery by the amount of the balance on the ground that the defendant had a counterclaim. But the result is obviously correct. It appears that the complaint and counterclaim are clumsy attempts at pleading in an action of equitable assumpsit. The judgment against the customer for the amount of the note less the "balance" is a judgment for the amount of the debit balance of the current account, *i.e.*, the amount by which the bank's transfers to the customer exceeded the customer's transfers to it.

If the promise of the customer is to repay at a future day the amounts transferred to him by way of loan insofar as his transfers to the bank in the meantime have not equalled the bank's transfers to him, what is the implied promise of the bank? Beyond question it is to lend by making transfers upon the customer's orders up to the amount of the credit balance in the customer's ledger account, including the amount of the note or that amount less a discount. What is the period during which the bank assures the customer that it will make and continue to make transfers by way of loan? In the light of the foregoing analysis there can be no doubt that the assurance terminates—the period for lending expires—on the day when the customer's promise to repay matures. Surely the promise is not to lend upon request at any time during the life of the customer. Bargains to lend in the future are based on credit judgments which do not look so far into the future. Again it would be surprising to find a lender promising to make advances after the time stipulated for repayment has arrived or to find a bank binding itself for indefinite future periods by commitments to lend.

In further support of the finding that the bank's promise expires by its terms on the day on which the note matures are the same arguments from the absurdity of the legal consequences resulting from any other finding. These were stated while there was under discussion the assumption of a bargain in which the customer's promise was that contained in the note and the bank's promise unlimited in point of time.

Thus the analysis reveals the bargain underlying the note transaction as a perfectly sensible agreement with simple and consistent legal consequences. The bank promises and is obligated to lend the agreed amount until the expiration of the agreed period and the customer promises and is obligated to pay at the end of that period the amount by which the transfers of the bank exceed his transfers to it. The customer's promissory note plays the part of collateral security for the customer's obligation. This it can do, because, though it does not subject the

³⁶ *Supra* note 29.

customer to a duty to pay the bank, the bank acquires a privileged power to pledge or discount—repledge or rediscount—it for its own obligations.

The note transaction is, therefore, in substance the familiar British device for extending bank credit for definite periods by means of a bargain between bank and customer obligating the bank to honor the customer's overdrafts up to a stated amount during a stated period and obligating the customer to pay the debit balance at the end of that period.³⁷ That device has been briefly described by Hamilton:

"An advance to a customer is made by allowing him to overdraw his account, and he is charged interest only on the variable balance owing from day to day. The advantage to the customer of an overdraft is that he only pays interest on the money which he actually uses, and not upon the whole amount which the bank may have agreed to advance to him. Moreover, every payment lodged to his credit reduces the amount of the indebtedness upon which interest is payable.

Various arrangements are made about allowing overdrafts so as to suit the different requirements of customers. A special contract is sometimes entered into to allow an overdraft for a named amount and a definite time. Where an agreement is entered into by a bank to allow an overdraft the bank is bound to honour the customer's cheques pursuant to the terms of the agreement, and if it refused to do so an action might be maintained and heavy damages recovered for dishonouring them."³⁸

A transaction in the form of a loan upon or a discount of a customer's note differs from a transaction in the form of an agreement for an overdraft in two respects. The former yields a credit instrument which may be of some value to the bank as collateral³⁹ for its borrowings and entitles the bank to interest upon the agreed amount during the term of the loan. The latter may put in the hands of the bank as collateral the obligations

³⁷ *Allen v. London County & Westminster Bank*, 84 L. J. K. B. 1286 (1915); *Bank of Australasia v. Palmer*, [1897] A. C. 540; *Bank of Victoria v. Brown*, 1 Vict. L. R. 47 (1875); *Laurie v. Scholefield*, L. R. 4 C. P. 622 (1869); *DAVIS, op. cit. supra* note 12, at 94; *GILBART, PRINCIPLES AND PRACTICE OF BANKING* (1870) 174, 399; *Grady, Use of the Trade Acceptance in British Domestic Business*, COMMERCE REPORTS FOR JULY 22, 1919 (No. 170) 417-418; *HAMILTON, LAW AND PRACTICE OF BANKING IN AUSTRALIA AND NEW ZEALAND* (2d ed. 1900) 150-179; *Interviews on Banking* (1911) REPORT NAT. MONETARY COMMISSION 135, 150, 165; *MINTY, ENGLISH BANKING METHODS* (2d ed. 1925) 288; *SHELDON, PRACTICE AND LAW OF BANKING* (2d ed. 1923) 444; *SPALDING, BANKERS' CREDITS* (1921) 9; *WITHERS, ENGLISH BANKING SYSTEM* (1910) 42.

³⁸ *HAMILTON, op. cit. supra* note 37, at 151-152.

³⁹ *DUNBAR, op. cit. supra* note 23, at 289; *GOLDENWEISER, FEDERAL RESERVE SYSTEM IN OPERATION* (1925) 9, 23; *AGGER, op. cit. supra* note 23, at 279.

of third persons which, whether negotiable or not, are not available for repledging, and entitles the bank to interest on the difference for the time being in favor of the bank on the current account.⁴⁰

It will be recalled that an entry for the amount of the customer's time note less the amount of the discount is made on the credit side of the individual ledger at the time of the loan.⁴¹ In most instances this entry is matched on the debit side by an entry for the amount of the loan or for the amount of the loan plus the discount.⁴² In the majority of such cases the customer gives the lending bank a "check" drawn on and payable to it for the amount of the loan (plus the discount, if any).⁴³ Obviously the "check" for an amount equalling the amount of the ledger credit resulting from the original credit for the loan (plus the discount, if any) does not, and is not intended to, effect a transfer of deposit currency in payment of the loan. The giving of the "check" and the making of the entry are alike pure formalities with no legal consequences except possibly as to the amount of the discount. The actual or supposed convenience of the bank in keeping its records dictates the debit entry. The giving of the "check" is doubtless the result of the observation that most debit entries in the account represent transfers of the medium of exchange made at the customer's order or request, and that the entry in question does not. Consequently, in order to give the transaction it represents the semblance of identity with a transfer at request, the practice of giving the "check" arose. But in a minority of such cases "checks" are not given. Nevertheless debit entries for an amount equalling the amount of the ledger credit (plus the discount, if any) resulting from the original credit of the loan are made. Sometimes the entry is made on the day of maturity. Sometimes, though the ledger credit exceeds the amount of the loan, the making of the entry is deferred.⁴⁴ If it is postponed, when the entry is made, at most it may be taken to signify the bank's decision no longer to permit overdrafts. But a decision to continue no longer the payment of checks which would result in overdrafts seems very like a decision no longer to honor checks which would not. Thus the debit entry is deceptively like the exercise of a power to terminate the bank's liability to honor checks. All this has made for confusion and the following misconceptions have become current: first, if the "check" is given, that the customer is paying the loan out of his ledger balance; second, if no "check" is given, that the debit entry for the

⁴⁰ DAVIS, *op. cit.* *supra* note 12, at 94; *supra* note 37.

⁴¹ *Supra* note 12.

⁴² *Supra* note 12.

⁴³ See the following articles in this series.

⁴⁴ See the following articles in this series.

amount of the loan (plus the discount, if any) has legal consequences beyond the amount of the discount; third, that apart from the discount they are different from the legal consequences of the debit entry made when the "check" is given; fourth, if the debit entry is made in the absence of the "check," that the making of the entry is the exercise by the bank of a power to reduce by the face of the note an existing obligation to pay the ledger balance. It is in order to give an explanation of the fictitious anomaly of the supposed legal consequences of the debit entry made where no "check" is given that recourse is had to the phrase banker's lien or banker's set-off.

But for the resulting confusion the *Delano* and *Goldstein* cases in all probability would not have been litigated. If they had, they would not have been reasoned in terms of whether or not the bank was invested with a legal power to set off and whether or not the sending of a notice was an integral element in the exercise of that power. The result reached in them, however, is the same as that which would have been reached had the discount transactions been subjected to the analysis proposed. While the report of the *Delano* case fails to indicate whether the check was presented on or after the day of maturity, this is immaterial as the bank's promise expired when it opened for business on that day and, simultaneously therewith, the customer's promise to pay the debit balance matured. Consequently, the fact that in the *Goldstein* case, the dishonored check was presented on the morning of the day of maturity makes no difference since the bank was no longer obligated to honor orders beyond the credit balance of the current account.

On the other hand, it seems that the decision in the *Callahan* case is contrary to the one which would have been reached if the proposed analysis had been followed. If it be supposed, however, that the day upon which the customer's promise to pay the debit balance was to be performed and upon which the bank's promise was to expire was later than the day of the maturity of the note given as collateral—not by any means a violent assumption if one looks beyond current practice—then the *Callahan* case may also be consistent with the suggested analysis.

In none of the three principal cases does it appear in the reports whether or not the note incorporated a provision that it was payable at the lending bank. Had the note been in terms payable at the lending bank that fact would afford no further support to the *Delano* and *Goldstein* decisions. Section 87 of the Uniform Negotiable Instruments Law⁴⁵ may permit the bank

⁴⁵ "Where the instrument is made payable at a bank it is equivalent to an order to the bank to pay the same for the account of the principal debtor thereon."

at which a note is made payable to debit to the maker's account an actual transfer by it of the medium of exchange to a third person who is the holder.⁴⁶ The presentation of the note by a third person may subject the bank to a duty to the customer to pay the holder, the breach of which will give the customer an action as in the case of a dishonored check.⁴⁷ But surely the clause will not give the customer an action in case of the bank's failure to pay to itself the amount of the note; nor will its alchemy create an actual transfer of the medium of exchange to a third person out of behavior which is neither a transfer nor to a third person. If it be urged that, by analogy, Section 87 be extended to give the payee bank a power to debit in cases such as these, a conclusive answer is that there is no need to extend it. There is no rent in the legal system through which the cases may slip; no hiatus to be bridged. There is no debit to be justified. The balance of transfers to and transfers by the bank is exactly the same as it was before the so-called debit. The obligation of the bank to honor orders is reduced because its promise has expired. The so-called debit is a meaningless entry in the individual ledger account made solely that that account may indicate the total amount of the bank's obligation to honor.

Although this article is not immediately concerned with transactions in which the customer gives his demand note for a loan, it is interesting to note that, if such a transaction be viewed in the light of the suggested analysis, a sensible underlying bargain and convincing legal consequences are apparent. It is well known that a demand note is the credit instrument regularly used if the period during which the loan is expected to continue is longer than the period of credit extension contemplated in transactions in which time notes are discounted. It is equally well known that the transaction is not one in which the bank makes no promise to lend whatever and in which the note is simply deposited as collateral security for such overdrafts as the bank may see fit to allow. A reasonable inference, therefore, is that the customer's promise is to pay upon a call or request to do so and that the bank's promise terminates or expires upon call or notice. This is the promise found in *Dawson v. Bank of New Zealand*.⁴⁸ It should be noted that this construction of the bargain in no way impinges upon the rule that a demand note is due

⁴⁶ *Heinrich v. First National Bank*, 219 N. Y. 1, 113 N. E. 531 (1916); *Peoples National Bank of Middletown v. Rhoades*, 28 Del. 65, 90 Atl. 409 (1913); *Baldwin's Bank of Penn Yan v. Smith*, 215 N. Y. 76, 80-82, 109 N. E. 138 (1915).

⁴⁷ *Dirnfield v. Fourteenth Street Bank*, 37 App. D. C. 11 (1911); *Clark v. Mt. Morris Bank*, 85 App. Div. 362, 83 N. Y. Supp. 447 (1st Dep't 1903), *aff'd*, 181 N. Y. 533, 73 N. E. 1133 (1905); *Brooke v. Tradesmen's National Bank*, 69 Hun 202, 23 N. Y. Supp. 802 (Sup. Ct., 1st Dep't 1893).

⁴⁸ 3 N. S. W. R. 154, 386 (1884).

and payable forthwith without demand. If collateral in the form of a credit instrument be required where the loan agreement is terminable upon notice, a demand note, whatever its consequent obligations may be, in its terms more nearly conforms to the underlying loan agreement than a time note. That the suggested construction is correct is indicated by the fact that a contrary construction in the only American case⁴⁹ deciding the point was followed by a statute attempting to override the decision.⁵⁰

⁴⁹ *Shuman v. Citizens State Bank of Rugby*, 27 N. D. 599, 147 N. W. 388 (1914).

⁵⁰ N. D. COMP. LAWS ANN. (Supp. 1925) § 5220a: "1. It shall be unlawful for any bank, or trust company, with which money has been deposited, to charge against the deposit any claim of such bank or trust company or any other person, or to appropriate the same to the payment of any debt to such bank or trust company or any other person, without legal process or without the consent of the depositor.

2. Any bank or trust company which shall so charge any claim against a deposit or in any way appropriate the same to the payment of a debt of the depositor, in violation of the terms hereof, shall be liable to the party aggrieved for any damages caused thereby to be recovered in a civil action."