REPORT BY THE COMMITTEE ON COMMERCIAL LAW AND UNIFORM STATE LAWS

SUPPORT FOR THE UNIFORM SPECIAL DEPOSITS ACT

I. Executive Summary

The New York City Bar Association ("City Bar") Committee on Commercial Law and Uniform State Laws (the "Committee") endorses enactment in the State of New York of the Uniform Special Deposits Act promulgated by the Uniform Law Commission (the "ULC") in 2023 (the "Act").[1] The ULC promulgated the Act after three years of extensive study and analysis by commercial law and banking law experts and observers, who had concluded that greater clarity was needed in the law of special deposits and drafted a model law recommended for enactment in all states that was tailored to provide that clarity.

The Act provides statutory recognition and protections for a useful type of bank account intended to fund a future payment to beneficiaries where the payment is contingent, unlike a general demand deposit account, the balance of which is accessible at the discretion of the depositor. Under the Act, a deposit that meets the statutory requirements specified in Section 5 of the Act (a "Special Deposit"), as set forth and further discussed in Section IV of this Report, is protected from interference by the depositor and any beneficiary, or any of their creditors or successors, until the occurrence of the contingency triggering the bank's disbursement obligation. An illustrative, non-exhaustive list of potential uses of Special Deposits is set out in Section 2(10) of the Act and is further described below in Sections IV and V.

The Act states what provisions in the account agreement are required to qualify an account as a Special Deposit entitled to the protections of the Act. It further specifies, with respect to the Special Deposit, the rights and obligations of the bank, depositor, beneficiaries (and creditors and successors of the depositor and beneficiaries) *vis-à-vis* each other. Disbursement of funds from a Special Deposit under the Act will generally not be interrupted by reason of intervening events such as service on the bank of creditor process, the bankruptcy of a depositor or a beneficiary, or the exercise of setoff rights by the bank at which the deposit is made.

This new Special Deposit should be distinguished from long-recognized common law special deposits, which have generally been considered by New York courts in the context of

[1] The full text of the Act is attached to this Report as Exhibit A. A short summary of the Act prepared by the ULC is attached to this Report as Exhibit B.

About the Association
The mission of the New York City Bar Association, which was founded in 1870 and has 23,000 members, is to equip and mobilize a diverse legal profession to practice with excellence, promote reform of the law, and uphold the rule of law and access to justice in support of a fair society and the public interest in our community, our nation, and throughout the world.

protecting the depositor from dilution by claims of other bank creditors in the event that the bank becomes insolvent. The Act does not address the insolvency of the depository bank. Common law special deposits are unaffected by the Act and may coexist with the new Special Deposit opt-in. The rules of the Act apply only to deposits which meet the specific statutory definition for a Special Deposit under the Act. Thus, the courts can continue to recognize and apply the case law governing common law special deposits to accounts which are not Special Deposits. In fact, a single account could arguably satisfy the requirements for both and therefore be entitled to the protections of both Special Deposits and, to the extent not inconsistent with the Act, common law.[2] Section II of this report describes the differences between common law special deposits and those under the Act in greater detail and explains why the common law governing special deposits should be supplemented by the clear rules of the Act. As described in Section III, the Act does not affect otherwise applicable law to the extent not inconsistent with the Act, particularly consumer protection law and the law governing payment of depositor claims in the event of the bank's insolvency.

Enactment of the Act will impose no cost on the New York government or taxpayers but will provide substantial benefits to New York. Section IV summarizes the provisions of the Act in detail, and Section V summarizes the benefits of the Act. The Act will make available a type of account that can protect consumers who are required to escrow funds in connection with agreements to purchase real property or to provide security deposits for performance of their leases, and the Act can protect employees whose employers use Special Deposits to satisfy their salary, IRA and 401(k) obligations. The Act will also provide businesses with a type of account that can protect funds deposited by financial institutions as collateral for, or otherwise in support of, the clearing or settlement of financial transactions or deposited by businesses of all types and sizes to discharge their obligations in a variety of other commercial transactions. Section V describes in more detail the beneficial uses of Special Deposits.

Enactment also will help protect New York's position as a preeminent financial center and the jurisdiction of choice for financial transactions and related litigation and will minimize the risk that New York-centered financial institutions may migrate banking, clearing or settlement operations to other enacting States to take advantage of the Act as enacted in those States. Section VI describes how institutions in the New York financial markets may take unique advantage of the use of Special Deposits, and finally, Section VII summarizes the disadvantages for New York if New York fails to enact the Act.

II. New York Common Law Affecting Special Deposits Does Not Provide Adequate Certainty and Protection

The current law on special deposits in New York and other states is non-statutory common law. This common law is used primarily to decide cases in which the bank has failed and a bank depositor asserts that it is not merely a general unsecured creditor of the insolvent bank, but is entitled to priority treatment because the bank held its deposit in a fiduciary capacity or as some

[2] For example, even though the depository bank has no fiduciary duties under the Act, the Act does not preclude the bank from agreeing to act as a fiduciary to satisfy the requirements for a common law special deposit as discussed in Part II. In contrast, a provision in the account agreement for such an account purporting to disclaim the bank's liability to beneficiaries would not be effective under the Act.

form of quasi-bailment of property.[3] As a result, much of the relevant case law is focused, first, on the question of whether the bank held the deposit as a fiduciary.[4] This fiduciary duty might arise, variously, from statute or common law.[5] Alternatively, it might arise from an express or implied contract. In addressing this question, the courts often wrestle with complex situations in which the fiduciary duty was not express but was argued to have been implied by or to be inferred from conflicting circumstances.[6] Second, if no fiduciary duty was found to exist, it does not matter that the bank knew that the deposit was intended by the depositor for some "specific purpose;" it had to be a segregated or identified fund for that specific purpose to qualify as a special deposit.[7] In short, there is often uncertainty as to when a deposit qualifies as a common law special deposit in the absence of a fiduciary duty. Third, even when such a fiduciary duty exists, the courts only award relief to the extent that the "special" deposit can be traced to unencumbered assets of the insolvent bank, thereby embroiling the courts in complex issues of tracing.[8] Fourth, a common law

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[3] *Peoples Westchester Sav. Bank v. Fed. Deposit Ins. Corp.,* 961 F.2d 327, 330 (2d Cir. 1992) (quoting *Marine Bank v. Fulton Bank,* 69 U.S. 252, 256 (1864)) (Defining a special deposit as one "in which the bank becomes a bailee of the depositor, the title of the thing deposited remaining with the latter…"). Subsequent case law makes clear that a special deposit does not involve an actual bailment, but rather an agreement of the bank to hold funds in the amount of a special deposit in trust or otherwise segregated from its business activities. *Merrill Lynch Mortg. Cap., Inc. v. F.D.I.C.*, 293 F. Supp. 2d 98 (D.D.C. 2003) (applying New York law).

[4] Note that special deposit case law in New York is not limited to cases concerning whether an insolvent bank held the deposit as a fiduciary. The cases also involve disputes as to the person to whom a bank, whether solvent or insolvent, owed the fiduciary duty. *See* footnote 8 below, *and see, e.g., Rogers Locomotive & Mach. Works v. Kelley*, 88 N.Y. 234 (1882); *Ehag Eisenbahnwerte Holding AG v. Banca Nationala a Romaniei*, 306 N.Y. 242, 117 N.E.d 346 (1954).

[5] *See Genesee Wesleyan Seminary v. U.S. Fid. & Guar. Co.*, 247 N.Y. 52, 159 N.E. 720 (1928) (Where treasurer of Seminary also personally conducted a banking business and took Seminary funds as deposits, that banker, as treasurer, was obligated by common law as a trustee of the Seminary's funds); *compare, Jennings v. U.S. Fid. & Guar. Co.*, 294 U.S. 216 (1935) (Although Indiana bank collection code provided that obligation of bank on unpaid negotiable instruments was fiduciary if bank became insolvent, that fiduciary duty created only on insolvency by state statute was unenforceable against national bank as inconsistent with federal law governing bank insolvencies).

[6] *Gray v. First Nat'l Bank & Trust Co.*, 263 N.Y. 479, 485, 189 N.E. 557 (1934) ("The fundamental question, however, is whether the contract between plaintiff and the bank served to create a trust fund in the hands of the bank to be used for a specific purpose. . . . Whether the whole or a part of a general deposit becomes by some transaction a special deposit or fund, to be kept intact and used for a specific purpose, depends, as in the case of any other contract, upon the intent of the parties."). *See Blakey v. Brinson*, 286 U.S. 254 (1932) (Stone, J.) (Where bank agreed to use funds in general deposit account to purchase bonds for depositor, but no bonds were purchased prior to bank insolvency, bank may have breached a duty to depositor, but there was no evidence of express or implied agreement to segregate or hold account balance in trust).

[7] The "specific purpose" requirement for a special deposit refers to the fact that the bank holds a special deposit as "an agent directly on behalf of the beneficial owner…" *Peoples Westchester Sav. Bank*, 961 F.2d at 331. *See also*, *In re Littman*, 258 N.Y. 468, 180 N.E. 174 (1932) (Where customer deposited funds to account for specific purpose of procuring a cable transfer to a person in a foreign country, bank had not impliedly agreed to segregate or hold funds in trust for that purpose). Note that under the New York common law if the bank owed a fiduciary duty to the depositor, no additional special purpose was required, but the bank's knowledge of or agreement to the depositor's special purpose was often used to support the claim that the bank had implicitly agreed to be a fiduciary.

[8] *See Jennings*, *supra*, (Even assuming collecting bank's duty to remit proceeds of collection of check to bank customer was a fiduciary duty, there were no traceable proceeds where bank had properly collected the check under statute and clearing house procedures by netting its aggregate obligations on checks payable to clearing house members against their aggregate obligations to pay items presented by bank for by collection, leaving a net balance owed by the bank to the clearing house.)

special deposit provides rights only to the person to whom the bank owes its fiduciary duty. This usually is the depositor but may be a designated beneficiary of the deposit where the depositor had relinquished control of the deposit and the bank had become the agent or trustee for the beneficiaries.[9]

New York common law of special deposits may be useful or necessary to protect against diminution of the account by reason of the bank's insolvency. However, if the parties are trying to use a common law special deposit for the purpose of ensuring that the deposit will be applied to its specific purpose when the disbursement contingency arises and that the disbursement will not be disrupted by bank setoff, creditor process or bankruptcy of the depositor or a beneficiary, then the four features of New York common law discussed above make it difficult for the parties to achieve that certainty under existing law.

In addition, there seems to be some uncertainty how courts in New York would apply the common law to find that a bank had effectively waived its right of setoff in connection with a special deposit, with New York state courts finding a waiver based on the bank's acquiescence in the depositor's specific purpose for the deposit and federal courts sitting in New York requiring the bank to have agreed to segregate the funds.[10] Where a bank accepts a deposit with knowledge of the depositor's special purpose, it would be useful to have greater clarity as to whether or not the bank has waived or limited its right to setoff. The Act provides that certainty.

The Act is focused entirely on creating a form of deposit that is useful for completing such contingent payments, without becoming embroiled in the other issues raised by common law special deposits. Therefore, the Act does not entitle a depositor to preferential treatment in the event of bank insolvency; this is a matter left to federal and state bank insolvency law. The Act also does not depend on, or give rise to, any fiduciary duty by the bank to the depositor or beneficiaries; the bank's contractual obligation to disburse the deposit as provided in an account agreement that meets the requirements of the Act is sufficient. For these two reasons, the establishment of a Special Deposit under the Act does not depend on whether the bank owes a fiduciary duty, and there is no need to trace the proceeds of the deposit. However, the Act does not

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[9] *See Rogers Locomotive, 88 N.Y. 234, at 238-240* (Finding that creditors of the depositor could not attach a deposit placed with the bank as trustee to be applied to a specific purpose); *Ehag Eisenbahnwerte Holding AG*, 306 N.Y. 242 at 251, 117 N.E.2d 346 (Finding no evidence of an agreement by the bank to pay the bondholder beneficiaries, the court declined to address "whether such an agreement would have significance … as it might tend to indicate that the depositor intended to part with all control over the funds and to constitute the bank a trustee or agent for the designated payee (cf. *Sayer* v. *Wynkoop,* 248 N.Y. 54, 57-58),…").

[10] *See Cassedy v. Johnstown Bank*, 246 App. Div. 337, 339, 286 N.Y.S. 202, 205 (1936) ("When a customer indicates that a deposit is made for a special purpose, the bank, by accepting the deposit, agrees to devote the fund to that purpose. It does not become merged with the general funds of the bank, and upon failure to devote it to the designated purpose, it must be returned to the depositor."); *Noah's Ark Auto Accessories, Inc. v. First Nat'l Bank,* 316 N.Y.S.2d 663, 666 (Sup. Ct. 1970) (Bank setoff improper because evidence showed bank had treated the account as special for some period before exercising setoff.) , *aff'd,* 37 A.D.2d 692, 323 N.Y.S.2d 408 (1971); *see also*, *Lewine v. Nat'l City Bank,* 222 App. Div. 74, 225 N.Y.S. 309 (1927), *aff'd,* 248 N.Y. 365, 162 N.E. 284 (1928). The federal courts sitting in New York appear to be more scrupulous in insisting on proof that the bank had either waived its right to setoff or had agreed to segregate the funds in the account. *In re Applied Logic Corp.*, 576 F.2d 952 (2d Cir. 1978) (bankruptcy court erred in denying bank right to setoff against debtor bank account that was not a special deposit); *Swan Brewery Co. v. U.S. Trust Co. of N.Y.*, 832 F. Supp. 714 (S.D.N.Y. 1993) (Setoff preserved where bank accepted funds but did not agree to waive right).

prohibit a bank from undertaking fiduciary duties; such an undertaking is simply not a requirement for obtaining the protections of the Act.

Furthermore, the Act does not recognize an implied "special deposit." Instead, the Act requires a record in which the bank expressly agrees that the deposit is held as a Special Deposit subject to the terms of the Act. The Act further clarifies that if the bank agrees that the deposit is a Special Deposit, it is thereby limiting its rights of setoff to those permitted by the Act. Additionally, it is essential that the deposit agreement identify the permissible purpose of the Special Deposit, specify the contingency that will trigger the bank's obligation to disburse the Special Deposit and provide a means for the bank to identify the beneficiaries.

In short, a deposit may be a Special Deposit even though it would not be a special deposit under the common law in the event the bank becomes insolvent. Once the Act's conditions are satisfied (including that the parties agree that their deposit should be governed by the Act), the Act's protections against interruption of disbursement become effective whether or not the account is a special deposit under common law. These protections apply to disruptive actions that might be taken by the bank itself (*e.g.,* setoff), the depositor or a beneficiary, or the creditors or other successors of the depositor or a beneficiary.

III. Scope and Limitations of the Act

The Act is designed to supplement, rather than disrupt, existing law. More specifically, it is intended to complement New York's general deposit law and its existing common law concerning general and special deposits to the extent that the law is not contrary to a provision of the Act. The Act provides an "opt-in" structure; it governs only when an account agreement provides that the deposit is to be governed by the Act and which otherwise satisfies the requirements of the Act for a Special Deposit. It does not apply to a general deposit or to a common law special deposit that does not comply with the Act. It also does not apply to accounts established with non-banks, and payments made using such accounts, and it does not apply to bank accounts not denominated in money, securities accounts, safe deposits, or physical asset safekeeping accounts. Finally, it does not address the rights of depositors of insolvent banks.

In addition, under Section 14 of the Act, other law supplements this Act, except to the extent inconsistent with the Act. The other laws include New York's Uniform Commercial Code, consumer protection law, law governing deposits generally, law related to escheat and abandoned or unclaimed property, and the principles of law and equity, including law related to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, and bankruptcy.

IV. Summary of Main Provisions of the Act

A. Requirements for a Special Deposit

Under Section 5 of the Act, a deposit is a Special Deposit if it is:

(1) a deposit of funds in a bank under an account agreement;

(2) for the benefit of at least two beneficiaries, one or more of which may be a depositor;

(3) denominated in a medium of exchange that is currently authorized or adopted by a domestic or foreign government;

(4) for a permissible purpose stated in the account agreement; and

(5) subject to a contingency.

Whether an account is a Special Deposit will be determined largely, if not entirely, by the terms of the account agreement and supplementary agreements, rather than (as may be the case for common law special deposits) extrinsic factual circumstances. The key to the identification of a Special Deposit is that the deposit is established under an "account agreement." That term is defined as an agreement in a record between a bank and one or more depositors that states the intention of the parties to establish a Special Deposit governed by the Act. This "opt in" feature ensures that only a deposit that the relevant parties intend to be covered by the Act will actually be a Special Deposit governed by the Act.

If the parties agree to statutory Special Deposit treatment under the Act, the account agreement must also provide for deposits to the account to be used for a "permissible purpose" and be disbursed upon the occurrence of a specified "contingency." The disbursement contingency will necessarily be closely related to and inform the particular permissible purpose. "Permissible purpose" is defined to mean "a governmental, regulatory, commercial, charitable, or testamentary objective of the parties stated in an account agreement."

The definition of permissible purpose in Section 2(10) of the Act also includes a non-exhaustive list of examples of such purposes. For example, a permissible purpose would include (a) holding funds in escrow, including for a purchase and sale, lease, buyback, or other transactions, (b) holding funds as a security deposit of a tenant, (c) holding funds that may be distributed to a person as remuneration, retirement or other benefit, or compensation under a judgment, consent decree, court order or other decision of a tribunal, (d) holding funds for distribution to a defined class after identification of class members and their interest in the funds, (e) providing assurance with respect to an obligation created by contract, such as earnest money, to ensure a transaction closes, (f) settling an obligation that arises in the operation of a payment system, securities settlement system, or other financial market infrastructure, (g) providing assurance with respect to an obligation that arises in the operation of a payment system, securities settlement system, or other financial market infrastructure, or (h) holding margin, other cash collateral, or funds that support the orderly functioning of financial market infrastructure or the performance of an obligation with respect to the infrastructure.

Section 6 provides that funds deposited after the bank[11] or a court has determined that the account does not serve a "permissible purpose" are not protected by Sections 8 through 11 (discussed below), and Comment 8 to Section 2 of the Act states that "a special deposit established for the purpose of defrauding or evading creditors until funds are disbursed would not be a permissible purpose" under the Act. The Comment is supported by Section 3(c)(2) of the Act

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[11] The bank may make such a determination and take necessary steps based on that determination under Section 6. Section 12(g) provides that the bank has no duty to do so, unless it agrees to under the account agreement.

discussed below. Thus, Special Deposits cannot be used to hinder, delay, or defraud the depositor's creditors.

A Special Deposit must also be for the benefit of at least two beneficiaries, one or more of which may be a depositor. A beneficiary is a person identified as such in the account agreement or, if not identified as a beneficiary in the account agreement, who may be entitled to payment from the Special Deposit upon the occurrence of a contingency specified in the account agreement or on termination of the Special Deposit. Not uncommonly, the depositor is a reversionary beneficiary entitled to return of funds not required to be used for the permissible purpose or entitled to return of undisbursed funds upon termination of the Special Deposit. A "contingency" is an event or circumstance specified in an account agreement that is not certain to occur but must occur before the bank is obligated to pay a beneficiary. Finally, the first and third clauses of Section 5 of the Act require that the deposit be a deposit of funds, denominated in a medium of exchange that is fiat currency of some government. Therefore, the bank's disbursement obligations cannot relate to any other form of property.

B. Limited Property Interest of Depositor or Beneficiary in Deposit

Section 8 of the Act provides that neither a depositor nor a beneficiary has a property interest in a Special Deposit. Any interest with respect to a Special Deposit is only in the bank's contingent obligation to disburse the Special Deposit once its obligation to pay such beneficiary has arisen (*i.e.,* the specified contingency is met) and becomes known to the bank. The nature of such a right to payment, including its transferability, would be determined under applicable law other than the Act.

C. Limited Enforceability of Creditor Process; Injunctions Against Bank

Section 9 of the Act provides that creditor process with respect to a Special Deposit is not enforceable against the bank holding the Special Deposit other than with respect to an amount that the bank is then obligated to pay a beneficiary (including the depositor) at the time the process is served, if the process (1) is served on the bank, (2) provides sufficient information to permit the bank to identify the depositor or the beneficiary and (3) gives the bank a reasonable opportunity to act on the process before it disburses funds to the beneficiary.

Section 10 of the Act provides that a court may enjoin, or grant similar relief that would have the effect of enjoining, a bank from paying a beneficiary (including the depositor) only if payment would constitute a material fraud or facilitate a material fraud with respect to the Special Deposit.

However, creditors of any person who funds a Special Deposit are not left without protection in the case of abuse of the Act. Section 3(c)(2) of the Act confirms that the Act does not affect the voidability of a deposit or transfer that is fraudulent or voidable under other law, including the Uniform Voidable Transactions Act adopted as Article 10 of New York's Debtor & Creditor Law. Accordingly, a transfer of funds to a Special Deposit may still be set aside if the transfer was made with the intention of the transferor to hinder, delay or defraud the transferor's creditors or the transfer was otherwise voidable under laws designed to protect creditors of the transferor.

D. Limitations of Bank's Rights of Recoupment and Set Off

Section 11 of the Act provides that, except in certain circumstances as described below, a bank may not exercise a right of recoupment or set off against a Special Deposit. In addition to discharging an obligation to pay a beneficiary when the obligation arises (*i.e.,* when the contingency specified in the account agreement occurs and the bank has knowledge of the occurrence), if the account agreement so authorizes, a bank may debit the Special Deposit for overdraft fees, costs incurred by the bank that relate directly to the Special Deposit or to reverse an earlier credit posted by the bank under circumstances warranted under other applicable law. The bank may also exercise a right of recoupment or set off an obligation owed to the bank by a beneficiary (including the depositor) against funds from the Special Deposit that the bank has become obligated to pay that beneficiary (which, once again, would be only after the contingency occurs and the bank has knowledge of the occurrence).

E. Protections for the Bank

The Act provides some important protections for a bank to encourage banks to offer Special Deposits to their customers. Section 12 of the Act states that a bank (unless otherwise agreed) does not have a fiduciary duty to any person with respect to a Special Deposit. While the bank is obligated to the class of beneficiaries of a Special Deposit, a debtor/creditor relationship with any particular beneficiary does not arise until the bank becomes obligated to pay that particular beneficiary. The bank has a duty to beneficiaries to comply with the account agreement and the Act. If the bank does not comply, the bank may be liable to a depositor or beneficiary only for damages proximately caused by the noncompliance. The bank may rely on records presented in compliance with the account agreement to determine whether the bank is obligated to pay a beneficiary. If an account agreement requires payment on presentation of a record, the bank must determine within a reasonable time whether the record is sufficient to require payment. If the account agreement requires action by the bank on the basis of a presented record, the bank is not liable for relying in good faith on the genuineness of a presented record that appears on its face to be genuine. Unless the account agreement provides otherwise, the bank is not required to determine whether a permissible purpose stated in the agreement continues to exist.

The Act sets a default rule that a Special Deposit terminates five years after the date the Special Deposit was first funded. If the bank cannot identify or locate a beneficiary entitled to payment at the time of termination, the bank must pay the balance to depositors who shall be beneficiaries. These provisions may be modified by the account agreement. A bank that disburses the remaining balance in compliance with the foregoing has no further obligations with respect to the Special Deposit.

F. Choice of Law and Forum Selection

Section 3 of the Act permits the parties to an account agreement to elect the application of the Act to a deposit by so stating in the account agreement, regardless of whether a party to the account agreement or a transaction related to the special deposit, or the special deposit itself, has a reasonable relation to the State of New York. A similar rule applies to the selection of a forum in New York for settling a dispute arising out of the Special Deposit.

G. Variation by Agreement

Section 4 of the Act provides for variation of the Act by agreement of the parties. Pursuant to Section 4, however, the effect of Sections 2 through 6, 8 through 11, and 14 may not be varied by agreement, except as provided in those sections. The effect of Sections 7, 12, and 13 may be varied by agreement, subject to the parameter that a provision in an account agreement or other record that substantially excuses liability or substantially limits remedies for failure to perform an obligation under the Act is not sufficient to vary the effect of a provision under the Act. Section 4 also clarifies protections for beneficiaries from amendments by account agreement signatories.

H. Transitional Provision

Section 16 of the Act provides that the Act applies to (i) a Special Deposit made under an account agreement executed on or after the effective date of the Act or (ii) a deposit made under an agreement executed before the effective date of the Act if all parties entitled to amend the agreement agree to make the deposit a Special Deposit and the deposit referenced in the amended agreement satisfies the criteria in Section 5 of the Act.

V. Benefits of the Act

Unlike the common law, the Act does not recognize an implied Special Deposit. It avoids uncertainty by not leaving the matter to case-by-case adjudication involving extrinsic circumstances and after-the-fact claims. The Act requires a record of contractual agreement to the application of the Act and compliance with the Section 5 requirements, rather than a subsequent court determination that the bank owes express or implied fiduciary duties to the depositor. That agreement evidences the bank's express limitation of its right of recoupment or setoff. The Act does not require tracing of account proceeds. The Act provides express protections to both the depositor and the beneficiaries of the intended purpose of the deposit, not merely to the depositor. The Act imposes clear duties on the bank to disburse the deposit and protects the bank against unintended fiduciary or implied duties. The Act expands the protections of a Special Deposit to all deposits specified as such and subject to disbursement to identifiable beneficiaries on a specified contingency and not merely to deposits which the bank has agreed to hold as trust funds in segregated accounts.

All of these features will benefit transacting parties by providing greater certainty with respect to a number of special deposit related issues, the resolutions of which may otherwise be uncertain. The Act does so while still preserving for the transacting parties a high degree of freedom of contract and the ability to continue using existing arrangements without disruption (unless the parties choose to amend their existing arrangements to take advantage of the protections provided by the Act).

A. Identification of a Special Deposit

The Act renders the elements required for a common law special deposit irrelevant. A deposit is a Special Deposit if the account agreement meets the requirements provided in Section 5 of the Act and the account agreement expressly provides, as required by Section 3(a) of the Act, that the special deposit is governed by the Act. The Comments to Section 12 of the Act also make clear that the law of bailment, trust or custody is not relevant to a Special Deposit. The relationship

between the bank and the depositor and beneficiaries is that of debtor-creditor unless otherwise agreed in the account agreement.

The Act does not abolish common law special deposits. Instead, the Act provides clear codified rules and protections without implicating any unnecessary issues to which common law special deposits may be subject.

B. Bankruptcy Remoteness

The Act also provides greater certainty to transacting parties by providing a statutory basis to negate a claim, if a depositor or beneficiary were to become subject to a case under the federal Bankruptcy Code, that the Special Deposit is property of the bankruptcy estate or subject to a bankruptcy stay or turnover order.

Section 8 of the Act provides that the depositor has no rights in the deposit except the depositor's specified contingent rights as a beneficiary and that a beneficiary has no rights in the Special Deposit itself. The right of a beneficiary (including a depositor as beneficiary) is only in the obligation of the bank to make payment upon occurrence of the specified contingency, not any right in the underlying deposit. No enforceable obligation against the bank exists prior to occurrence of the relevant contingency.[12]

The clarifications provided in Section 8 are important in a bankruptcy case. Under the federal Bankruptcy Code property rights are determined by non-bankruptcy law, usually state law, absent a compelling federal interest to the contrary. *Butner v. United States*, 440 U.S. 48 (1979). A trustee or other estate representative in a bankruptcy case of a depositor or beneficiary will be bound by the terms of the Act that circumscribe the beneficiary's rights, with the result that the Special Deposit itself should not be an asset of the bankruptcy estate.[13]

C. Protection from Creditor Process

As discussed above in Part IV.C of this report, Section 9 of the Act clarifies to what extent a creditor of a depositor or beneficiary has recourse to the Special Deposit to satisfy any claim owing to the creditor. Section 9 provides important statutory protections to the beneficiaries which might not otherwise be available to a common law special deposit if a court were to impose the asset segregation/trust requirement for a common law special deposit. These legal protections also might not be available even to a beneficiary of a common law special deposit over which the depositor had maintained control, leaving the depositor's rights subject to attachment by the depositor's creditors. The legal effect of an assignment of rights by a beneficiary on persons other than the bank while the beneficiary's rights remain contingent, or of process served by a creditor

[12] Other applicable law determines what rights, such as the right to transfer, a beneficiary may have, if any, in the contingent right to payment before the contingencies have been met.

[13] Note that the beneficiary of a payment that is funded by a Special Deposit may still, under appropriate circumstances, be a potential defendant in a fraudulent transfer or preference claim by the bankruptcy estate of the funder of the deposit.

of a beneficiary, before the bank becomes obligated to pay such beneficiary are matters left to other applicable law.

D. Strength of the Bank's Promise to Pay

Sections 10 and 12 of the Act provide certainty to transacting parties as to the strength of the bank's promise to pay the beneficiary. Section 12 of the Act states that the bank has a duty to the beneficiary to comply with the account agreement and allows for actual damages against the bank in the case of the bank's failure to comply. Section 10 limits injunctive relief against a bank with respect to a Special Deposit to circumstances in which fraud has occurred or the facilitation of a material fraud would occur. Even in that case the traditional elements for obtaining equitable relief in the form of an injunction must be met. The two sections together render the bank's promise to pay the beneficiary a solid one, similar to the promise of a bank obligated to honor a draw on a letter of credit when proper presentment is made.

E. Protection from Bank Setoff Rights

As discussed in Part IV.D of this report, Section 11 of the Act provides needed guidance as to the limited extent a bank may recoup or set off against the Special Deposit for amounts owed to the bank in the administration of the deposit.

F. Freedom of Contract

The key statutory protections providing certainty to beneficiaries, depositors, the creditors of each, and to the bank are protected from impairment by Section 4 of the Act, which precludes the account agreement from (i) varying the effect of Sections 2 through 6, 8 through 11 and 14 or (ii) varying the effect of Sections 7, 12 or 13 so as to substantially excuse liability or limit remedies for failure to perform a statutory obligation. Nevertheless, the benefits of freedom of contract are recognized by provisions in various individual sections permitting contractual variance. Further, the "opt-in" framework of the Act ensures that contracting parties retain the autonomy to decide whether they wish their transaction to be governed by the Act at all.

VI. Examples of How a Special Deposit May Be Used in New York

The definition of "permissible purpose" in Section 2(10) of the Act contains a non-exclusive list of examples of transactions for which the Act may be useful. However, that list is not exhaustive.

A prime example of the use of a Special Deposit would be to facilitate the funding of interest, sinking fund and principal payments by the issuer of publicly traded notes or bonds. The issuer and its paying agent bank would agree to the opening of a Special Deposit account into which the issuer would wire the upcoming payment, subject to the paying agent's agreement to transfer the deposit to the registered holder of the security—such as Depository Trust Company ("DTC")—on the contingency related to a payment becoming due and payable. In the event of the issuer's insolvency after deposit, the Special Deposit would be immune from process by the issuer's creditors, recoupment or setoff by the paying agent bank or claims that the funds constitute part of the issuer's bankruptcy estate in a bankruptcy proceeding, and the paying agent could not be enjoined from further transfer to the registered holder of the bonds or notes once the contingency

is satisfied. The registered holder, if a custodian—such as DTC—for beneficial owners or security entitlement holders, in turn, could, itself use Special Deposits with its bank to effect subsequent transfers to its participants or beneficial owners. Such Special Deposits might also be documented so as to constitute common law special deposits, protected against the insolvency of the bank serving as paying agent or other intermediary.

Another primary example of a permissible purpose would involve a payment system operator who would use Special Deposits to facilitate funds transfers between financial institution participants. Rather than having its participants prefund general deposits at the operator's bank, which would be subject to risk of the possible insolvencies of the operator or the participating financial institutions, bank recoupment or setoff or creditor process against the operator or depositing banks, the payment system operator would have the financial institutions participating in the network prefund each day a Special Deposit at the operator's bank. These financial institutions would be identified as potential beneficiaries and would be entitled to disbursement at the end of each day on the contingency of the bank's receiving computation from the operator as to the appropriate distributions to each beneficiary. Such Special Deposits might also be documented so as to constitute common law special deposits, which would be protected against the insolvency of the operator's bank.

If the conditions for a Special Deposit were satisfied, the Act might also be useful for other types of transactions, such as (a) cash management arrangements among companies in a group by which funds of the group are consolidated for more efficient treasury investing, (b) tax sharing arrangements among companies in a consolidated tax group, (c) deposits of funds to pay commissions to consignors or commission merchants on sales of goods by retailers, (d) planning for the special needs of family members, and (e) a deposit of funds to support issuance of a stablecoin denominated in money and to fund redemption payments made to holder of such stablecoins. In each of these situations and others the protections afforded to the Special Deposit will be attractive to transacting parties within the rules circumscribed by the Act.

VII. Adverse Consequences of Failing to Enact the Act in New York

Enactment of the Act imposes no cost on New York or its residents. But failure to enact the Act in New York could impair New York's position as the preeminent financial center and the jurisdiction of choice for financial transactions and related litigation. A key purpose of the Act is to protect and bring greater certainty to broad swaths of daily financial transactions–including securities settlements, payment systems, and margin or other security arrangements–that are critical parts of the infrastructure of United States financial markets. These operations are centered in New York, and financial market infrastructure and other financial institutions handle trillions of dollars of such transactions every day. Their agreements and system rules typically are governed by New York law and choose a New York forum for resolution of disputes. If the Act is enacted in other jurisdictions but not New York, the transactions may well migrate from New York to enacting states. Banks and financial market infrastructures could move their Special Deposits to enacting states to take advantage of the Act's benefits and also choose an enacting state as the governing law for their contracts and rules as well as for the forum for any related litigation. The resulting reputational and commercial loss to New York could be substantial.

Moreover, failure to enact the Act in New York will not just impact large financial market participants. The failure also may disproportionately disadvantage New York's consumers and small business owners. These persons commonly use various types of escrow arrangements, some of which may qualify as common law special deposits, with the attendant legal uncertainties discussed above. A Special Deposit could clarify the rights of such consumers and small business owners, but, absent enactment, the protections provided to beneficiaries of Special Deposits will not be easily available to New York residents.

Furthermore, those New York consumers may be misled as to their protections under existing New York law. These are people who, often unrepresented by counsel, may find themselves required under the terms of a transaction to deposit funds into something which may be labelled a "special deposit" governed by New York law, but which fails to satisfy New York's common law rules for any of the protections of a special deposit and which provides no third-party beneficiary rights. Unsophisticated parties may, understandably, assume that mere designation of a New York bank account as a "special deposit" means that the funds are immune from creditor legal process or bankruptcy filing against the bank customer, or the bank's recoupment or setoff of the account to satisfy the depositor's debt. In contrast, larger and more sophisticated parties will be able to protect themselves by negotiating a governing law clause which selects the law of an enacting state and electing to opt into coverage under the Act as enacted in that state.

Failure to enact the Act in New York would deprive New York consumers, businesses, financial institutions, and deposit beneficiaries of a new and versatile tool to facilitate many types of transactions. It would leave them with a common law special deposit that is of little or no utility in providing the protections provided by the Act for the reasons set out in Section II. As noted, the Act promises to benefit consumers and businesses by providing a clear and codified mechanism for a wide variety of important financial transactions, including real estate escrows, securities settlements, security deposits, and the funding of pension and other business obligations, without imposing any of these mechanisms on parties unless they choose to "opt in" to application of the Act. The Act protects all parties to a Special Deposit from unnecessary risks of creditor process, bankruptcy and bank recoupment and setoff claims, risks that are all present under existing New York law. The potential for these benefits and protections may be lost to New Yorkers if New York fails to enact the Act.

VIII. Recommendations of the Committee

For all of the above reasons, the Committee supports and recommends the enactment of the Act in New York.

Curt Mechling, Chair
Commercial Law and Uniform State Laws Committee

March 2024

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Exhibit A

Uniform Special Deposits Act

Uniform Special Deposits Act

drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT
IN ALL THE STATES

NO COMMENTS

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ON UNIFORM STATE LAWS

January 26, 2024

Uniform Special Deposits Act

Section 1. Title

This [act] may be cited as the Uniform Special Deposits Act.

Section 2. Definitions

In this [act]:

(1) “Account agreement” means an agreement that:

(A) is in a record between a bank and one or more depositors;

(B) may have one or more beneficiaries as additional parties; and

(C) states the intention of the parties to establish a special deposit governed by this [act].

(2) “Bank” means a person engaged in the business of banking and includes a savings bank, savings and loan association, credit union, [and] trust company[, and a bank as defined in [cite to state statute]]. Each branch or separate office of a bank is a separate bank for the purpose of this [act].

(3) “Beneficiary” means a person that:

(A) is identified as a beneficiary in an account agreement; or

(B) if not identified as a beneficiary in an account agreement, may be entitled to payment from a special deposit:

(i) under the account agreement; or

(ii) on termination of the special deposit.

(4) “Contingency” means an event or circumstance stated in an account agreement that is not certain to occur but must occur before the bank is obligated to pay a beneficiary.

(5) “Creditor process” means attachment, garnishment, levy, notice of lien, sequestration, or similar process issued by or on behalf of a creditor or other claimant.

(6) “Depositor” means a person that establishes or funds a special deposit.

(7) “Good faith” means honesty in fact and observance of reasonable commercial standards of fair dealing.

(8) “Knowledge” of a fact means:

(A) with respect to a beneficiary, actual knowledge of the fact; or

(B) with respect to a bank holding a special deposit:

(i) if the bank:

(I) has established a reasonable routine for communicating material information to an individual to whom the bank has assigned responsibility for the special deposit; and

(II) maintains reasonable compliance with the routine, actual knowledge of the fact by that individual; or

(ii) if the bank has not established and maintained reasonable compliance with a routine described in clause (i) or otherwise exercised due diligence, implied knowledge of the fact that would have come to the attention of an individual to whom the bank has assigned responsibility for the special deposit.

(9) “Obligated to pay a beneficiary” means a beneficiary is entitled under the account agreement to receive from the bank a payment when:

(A) a contingency has occurred; and

(B) the bank has knowledge the contingency has occurred.

“Obligation to pay a beneficiary” has a corresponding meaning.

(10) “Permissible purpose” means a governmental, regulatory, commercial, charitable, or testamentary objective of the parties stated in an account agreement. The term includes an objective to:

(A) hold funds:

(i) in escrow, including for a purchase and sale, lease, buyback, or other transaction;

(ii) as a security deposit of a tenant;

(iii) that may be distributed to a person as remuneration, retirement or other benefit, or compensation under a judgment, consent decree, court order, or other decision of a tribunal; or

(iv) for distribution to a defined class of persons after identification of the class members and their interest in the funds;

(B) provide assurance with respect to an obligation created by contract, such as earnest money to ensure a transaction closes;

(C) settle an obligation that arises in the operation of a payment system, securities settlement system, or other financial market infrastructure;

(D) provide assurance with respect to an obligation that arises in the operation of a payment system, securities settlement system, or other financial market infrastructure; or

(E) hold margin, other cash collateral, or funds that support the orderly functioning of financial market infrastructure or the performance of an obligation with respect to the infrastructure.

(11) "Person" means an individual, estate, business or nonprofit entity, government or governmental subdivision, agency, or instrumentality, or other legal entity. The term includes a protected series, however denominated, of an entity if the protected series is established under law that limits, or limits if conditions specified under law are satisfied, the ability of a creditor of the entity or of any other protected series of the entity to satisfy a claim from assets of the protected series.

(12) "Record" means information:

(A) inscribed on a tangible medium; or

(B) stored in an electronic or other medium and retrievable in perceivable form.

(13) "Special deposit" means a deposit that satisfies Section 5.

(14) "State" means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any other territory or possession subject to the jurisdiction of the United States. The term includes an agency or instrumentality of the state.

Legislative Note: *The bracketed text in paragraph (2) should be included if a state defines "bank" in another statute and intends for the definition to apply to this act.*

A state should enact the definition of "person" in paragraph (11) regardless of whether the state has enacted the Uniform Protected Series Act (2017) or otherwise recognizes a protected series under its law. The Uniform Special Deposits Act does not require the enacting state to recognize a limit on liability of a protected series organized under the law of another jurisdiction or a limit on liability of the entity that established the protected series. The Uniform Special Deposits Act clarifies the status of a protected series as a "person" under the choice-of-law and substantive law rules of the enacting state under the Uniform Special Deposits Act.

Section 3. Scope; Choice of Law; Forum

(a) This [act] applies to a special deposit under an account agreement that states the intention of the parties to establish a special deposit governed by this [act], regardless of whether

a party to the account agreement or a transaction related to the special deposit, or the special deposit itself, has a reasonable relation to this state.

(b) The parties to an account agreement may choose a forum in this state for settling a dispute arising out of the special deposit, regardless of whether a party to the account agreement or a transaction related to the special deposit, or the special deposit itself, has a reasonable relation to this state.

(c) This [act] does not affect:

(1) a right or obligation relating to a deposit other than a special deposit under this [act]; or

(2) the voidability of a deposit or transfer that is fraudulent or voidable under other law.

Section 4. Variation by Agreement or Amendment

(a) The effect of Sections 2 through 6, 8 through 11, and 14 may not be varied by agreement, except as provided in those sections. Subject to subsection (b), the effect of Sections 7, 12, and 13 may be varied by agreement.

(b) A provision in an account agreement or other record that substantially excuses liability or substantially limits remedies for failure to perform an obligation under this [act] is not sufficient to vary the effect of a provision of this [act].

(c) If a beneficiary is a party to an account agreement, the bank and the depositor may amend the agreement without the consent of the beneficiary only if the agreement expressly permits the amendment.

(d) If a beneficiary is not a party to an account agreement and the bank and the depositor know the beneficiary has knowledge of the agreement's terms, the bank and the depositor may

amend the agreement without the consent of the beneficiary only if the amendment does not adversely and materially affect a payment right of the beneficiary.

(e) If a beneficiary is not a party to an account agreement and the bank and the depositor do not know whether the beneficiary has knowledge of the agreement's terms, the bank and the depositor may amend the agreement without the consent of the beneficiary only if the amendment is made in good faith.

Section 5. Requirements for Special Deposit

A deposit is a special deposit if it is:

(1) a deposit of funds in a bank under an account agreement;

(2) for the benefit of at least two beneficiaries, one or more of which may be a depositor;

(3) denominated in a medium of exchange that is currently authorized or adopted by a domestic or foreign government;

(4) for a permissible purpose stated in the account agreement; and

(5) subject to a contingency.

Section 6. Permissible Purpose

(a) A special deposit must serve at least one permissible purpose stated in the account agreement from the time the special deposit is created in the account agreement until termination of the special deposit.

(b) If, before termination of the special deposit, the bank or a court determines the special deposit no longer satisfies subsection (a), Sections 8 through 11 cease to apply to any funds deposited in the special deposit after the special deposit ceases to satisfy subsection (a).

(c) If, before termination of a special deposit, the bank determines the special deposit no

longer satisfies subsection (a), the bank may take action it believes is necessary under the circumstances, including terminating the special deposit.

Section 7. Payment to Beneficiary by Bank

(a) Unless the account agreement provides otherwise, the bank is obligated to pay a beneficiary if there are sufficient actually and finally collected funds in the balance of the special deposit.

(b) Except as provided in subsection (c), the obligation to pay the beneficiary is excused if the funds available in the special deposit are insufficient to cover such payment.

(c) Unless the account agreement provides otherwise, if the funds available in the special deposit are insufficient to cover an obligation to pay a beneficiary, a beneficiary may elect to be paid the funds that are available or, if there is more than one beneficiary, a pro rata share of the funds available. Payment to the beneficiary making the election under this subsection discharges the bank's obligation to pay a beneficiary and does not constitute an accord and satisfaction with respect to another person obligated to the beneficiary.

(d) Unless the account agreement provides otherwise, the obligation of the bank obligated to pay a beneficiary is immediately due and payable.

(e) The bank may discharge its obligation under this section by:

(1) crediting another transaction account of the beneficiary; or

(2) taking other action that:

(i) is permitted under the account agreement for the bank to obtain a discharge; or

(ii) otherwise would constitute a discharge under law.

(f) If the bank obligated to pay a beneficiary has incurred an obligation to discharge the obligation of another person, the obligation of the other person is discharged if action by the bank under subsection (e) would constitute a discharge of the obligation of the other person under law that determines whether an obligation is satisfied.

Section 8. Property Interest of Depositor or Beneficiary

(a) Neither a depositor nor a beneficiary has a property interest in a special deposit.

(b) Any property interest with respect to a special deposit is only in the right to receive payment if the bank is obligated to pay a beneficiary and not in the special deposit itself. Any property interest under this subsection is determined under other law.

Section 9. When Creditor Process Enforceable Against Bank

(a) Subject to subsection (b), creditor process with respect to a special deposit is not enforceable against the bank holding the special deposit.

(b) Creditor process is enforceable against the bank holding a special deposit with respect to an amount the bank is obligated to pay a beneficiary or a depositor if the process:

(1) is served on the bank;

(2) provides sufficient information to permit the bank to identify the depositor or the beneficiary from the bank's books and records; and

(3) gives the bank a reasonable opportunity to act on the process.

(c) Creditor process served on a bank before it is enforceable against the bank under subsection (b) does not create a right of the creditor against the bank or a duty of the bank to the creditor. Other law determines whether creditor process creates a lien enforceable against the beneficiary on a contingent interest of a beneficiary, including a depositor as a beneficiary, even if not enforceable against the bank.

Section 10. Injunction or Similar Relief

A court may enjoin, or grant similar relief that would have the effect of enjoining, a bank from paying a depositor or beneficiary only if payment would constitute a material fraud or facilitate a material fraud with respect to a special deposit.

Section 11. Recoupment or Set Off

(a) Except as provided in subsection (b) or (c), a bank may not exercise a right of recoupment or set off against a special deposit.

(b) An account agreement may authorize the bank to debit the special deposit:

(1) when the bank becomes obligated to pay a beneficiary, in an amount that does not exceed the amount necessary to discharge the obligation;

(2) for a fee assessed by the bank that relates to an overdraft in the special deposit account;

(3) for costs incurred by the bank that relate directly to the special deposit; or

(4) to reverse an earlier credit posted by the bank to the balance of the special deposit account, if the reversal occurs under an event or circumstance warranted under other law of this state governing mistake and restitution.

(c) The bank holding a special deposit may exercise a right of recoupment or set off against an obligation to pay a beneficiary, even if the bank funds payment from the special deposit.

Section 12. Duties and Liability of Bank

(a) A bank does not have a fiduciary duty to any person with respect to a special deposit.

(b) When the bank holding a special deposit becomes obligated to pay a beneficiary, a debtor-creditor relationship arises between the bank and beneficiary.

(c) The bank holding a special deposit has a duty to a beneficiary to comply with the account agreement and this [act].

(d) If the bank holding a special deposit does not comply with the account agreement or this [act], the bank is liable to a depositor or beneficiary only for damages proximately caused by the noncompliance. Except as provided by other law of this state, the bank is not liable for consequential, special, or punitive damages.

(e) The bank holding a special deposit may rely on records presented in compliance with the account agreement to determine whether the bank is obligated to pay a beneficiary.

(f) If the account agreement requires payment on presentation of a record, the bank shall determine within a reasonable time whether the record is sufficient to require payment. If the agreement requires action by the bank on presentation of a record, the bank is not liable for relying in good faith on the genuineness of the record if the record appears on its face to be genuine.

(g) Unless the account agreement provides otherwise, the bank is not required to determine whether a permissible purpose stated in the agreement continues to exist.

Section 13. Term and Termination

(a) Unless otherwise provided in the account agreement, a special deposit terminates five years after the date the special deposit was first funded.

(b) Unless otherwise provided in the account agreement, if the bank cannot identify or locate a beneficiary entitled to payment when the special deposit is terminated, and a balance remains in the special deposit, the bank shall pay the balance to the depositor or depositors as a beneficiary or beneficiaries.

(c) A bank that pays the remaining balance as provided under subsection (b) has no

further obligation with respect to the special deposit.

Section 14. Principles of Law and Equity

[Cite to state's Uniform Commercial Code], consumer protection law, law governing deposits generally, law related to escheat and abandoned or unclaimed property, and the principles of law and equity, including law related to capacity to contract, principal and agent, estoppel, fraud, misrepresentation, duress, coercion, mistake, and bankruptcy, supplement this [act] except to the extent inconsistent with this [act].

Section 15. Uniformity of Application and Construction

In applying and construing this uniform act, a court shall consider the promotion of uniformity of the law among jurisdictions that enact it.

Section 16. Transitional Provision

This [act] applies to:

(1) a special deposit made under an account agreement executed on or after [the effective date of this [act]]; and

(2) a deposit made under an agreement executed before [the effective date of this [act]], if:

(A) all parties entitled to amend the agreement agree to make the deposit a special deposit governed by this [act]; and

(B) the special deposit referenced in the amended agreement satisfies Section 5.

[Section 17. Severability]

[If a provision of this [act] or its application to a person or circumstance is held invalid,

the invalidity does not affect another provision or application that can be given effect without the invalid provision.]

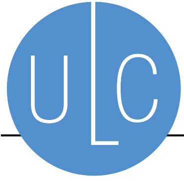
Legislative Note: *Include this section only if the state lacks a general severability statute or a decision by the highest court of the state stating a general rule of severability.*

Section 18. Effective Date

This [act] takes effect . . .

Exhibit B

Uniform Law Commission Summary of the Uniform Special Deposits Act (2023)



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The Uniform Special Deposits Act (2023)

Summary

Special deposits perform vital work in commerce and industry throughout the United States. While a special deposit is a bank liability and has some of the characteristics of a general bank deposit, there are also important differences. Unlike a demand deposit, a special deposit is not subject to transfer on the order of the depositor. Instead, it is payable upon the occurrence of a contingency, like the closing of a sale of real estate, the distribution of funds to class members after the court approves of the settlement of a class action, or the distribution of a commercial tenant's security deposit when the leasehold ends. Further, the bank's creditor in the case of a special deposit may be unknown until the contingency has occurred. This is different from the general deposit, where the bank's creditor is known from the outset as the depositor.

Special deposits serve different purposes. Some special deposit accounts provide security to one party to a commercial transaction that the other party will perform. The earnest money taken at the time of contract and held until the closing is an example of this form. Other special deposits are used as vehicles for the collection of funds that will be distributed upon some anticipated occurrence, like the settlement of a class action. Other special deposits may give the parties to a settlement system confidence in the financial wherewithal of the other parties in the system that settlement will occur. Special deposits come in all forms and in varied sizes. In the sale of residential real estate, a special deposit may have a balance of less than $100 thousand. With respect to certain financial infrastructure, a special deposit may hold cash margin in an amount in excess of $1 billion.

Special deposits are highly useful because they are safe, secure, and efficient. Safety and security are provided by a regulated bank, banking regulation (including the regulators), and perhaps deposit insurance. Efficiency is provided by the simplicity of the deposit account mechanism, its relatively low cost, and the fact that banks typically provide a return on the principal balance of deposits in the form of interest. But, notwithstanding their utility, some commercial actors eschew the use of the special deposit because its function is not well understood, and because there are uncertainties in the case law that create what is perceived as risk. The Uniform Special Deposit Act provides an infrastructure for special deposits that permits commercial actors to understand the mechanism, and, at the same time, it addresses the principal uncertainties that may be undermining the utility of special deposits. The Uniform Special Deposits Act (the "Act") also clarifies what the special deposit is, and what it isn't. Various state case law characterizes special deposits as something akin to a trust, bailment, or agency – which characterizations do not accurately describe these bank products. Existing case law creates even more confusion because it sometimes references bank practices that have not been followed since the *Pony Express*, like banks holding cash in custody for the depositor. A combination of these uncertainties prevents special deposits from serving their salutary purpose, and these uncertainties have been addressed in this note as "mischiefs" to be remedied.

Opt-In Statute

The Special Deposit Act is an "opt-in" statute. No bank is currently required to offer a special deposit product. Enactment of the Act will not change this current condition. If a bank and its customer(s) want to have a special deposit covered by the Act, they can "opt in" to coverage in the account agreement. If they do not "opt in" by a clear statement in the account agreement, the deposit contract will continue to be covered by common law and not by the Act.

The First Mischief: Identification of the Special Deposit

Special deposits are to be used for a particular purpose after a stated event or circumstance has occurred. In modern banking practice, there is considerable uncertainty what makes a general deposit "special". The Uniform Special Deposits Act eliminates all that uncertainty.

To be covered as a special deposit, Section 2 of the Act requires the account agreement memorializing the deposit contract to include language stating the parties' intent to establish a special deposit. Under the Act, a special deposit is a deposit of funds in a bank subject to a contingency, for the benefit of at least two beneficiaries (one or more of whom may be a depositor), denominated in money, and for a permissible purpose that must be stated in the account agreement. If all those things exist, the deposit is a special deposit covered by the Act. If they do not all exist, we may have a special deposit, but it will be governed by contract and case law rather than the Act.

There are some important safeguards in the Act, including the permissible purpose requirement. The special deposit receives unique protection under the Act, and it is possible that someone might attempt to abuse the protection. Section 3 of the Act provides for a safeguard; it expressly preserves "the voidability of a deposit or transfer that is fraudulent or voidable under other law." The permissible purpose is another important safeguard. A permissible purpose is defined in Section 2 as "a governmental, regulatory, commercial, charitable, or testamentary objective of the parties stated in the account agreement." A special deposit must serve a permissible purpose from creation until termination. If the special deposit ceases to serve such a purpose before termination, the protections of the Act will not apply to any funds deposited in the account from the point that it ceases to serve the permissible purpose.

The Second Mischief: Bankruptcy of the Depositor

The Uniform Special Deposits Act clarifies the treatment of a special deposit in the event of the bankruptcy of a depositor. Under the current law, a depositor is deemed to have rights to a bank deposit. The case law is not sufficiently benign to distinguish the special deposit, which unlike the general deposit is not payable to the depositor or in accordance with the depositor's order. Instead, the determination of a contingency resolves who will be paid the proceeds of the special deposit. The Act has a provision that makes this distinction clear, and it affirmatively refutes the notion that the depositor has rights in the special deposit. Consequently, under the Act, the special deposit will not be swept into a depositor's bankruptcy proceeding, because the special deposit is not an asset of the depositor's bankruptcy estate.

For example, imagine a commercial office building where the landlord requires tenants to post a security deposit. The landlord may put each tenant's security deposit into a single, comingled account. If there is no damage to the property at the end of the lease, the security deposit is due to the tenant. Now, imagine that the landlord declares bankruptcy and the tenant's security deposit is caught up in the bankruptcy proceeding as an asset of the landlord. The Act eliminates the uncertainty whether the tenant's security deposit will be swept into a landlord's bankruptcy proceeding simply because the landlord is the depositor. The Act clearly provides in Section 8 that, in this hypothetical case, the landlord has no "property interest in the special deposit."

Section 8 of the Act makes the special deposit "bankruptcy remote," meaning that the only right is "the right to receive payment if the bank is obligated to pay a beneficiary . . . ." There is no right in the special deposit itself.

The Third Mischief: Premature Creditor Process

The Act protects the special deposit from a premature attack by a creditor, where the balance of the special deposit could be drawn into an unrelated conflict, or frozen for a period of time that was not within the contemplation of the parties. Consider, for example, a special deposit that is being used to collect the payroll of an automobile manufacturer that will use the collected funds in the special deposit to pay all of its factory workers. Assume that one of those workers is indebted to a retail store, and that the retail store has converted the defaulted debt into a judgment. The judgment creditor then levies on the special deposit, in which the individual factory worker would have an interest under the law of many states. Because of that worker's interest, the entire deposit account could be restrained, and in that case no worker would be paid. This would be a bad result for the manufacturer and its workers.

The Act eliminates the uncertainty about such premature creditor process. First, Section 9 of the Act makes clear that "creditor process with respect to a special deposit is not enforceable against the bank holding the special deposit." Creditor process may be enforceable "against the bank holding a special deposit with respect to an amount the bank is obligated to pay a beneficiary", but this can happen only after determination of the contingency. In the hypothetical case about the payroll account, the special deposit would be absolutely insulated from the creditor's attack. The creditor might be able to restrain the individual salary payment to the worker/debtor who is also a judgment debtor, but only when the bank is obligated to that worker (after determination of the contingency). Section 9 makes clear that there is no "right of the creditor against the bank or a duty of the bank to the creditor." In short, the uncertainty about premature creditor process is eliminated by the Act.

The Fourth Mischief: Bank Setoff

The fourth and final mischief concerns the bank holding the special deposit and the prospect that the bank might exercise a right of set off or recoupment. Under many deposit contracts, the bank receiving the deposit is granted very broad rights of setoff and recoupment. These rights might then be exercised with respect to past-due indebtedness on the part of anyone interested in the deposit. As a result, uncertainty is created of a kind that produces a fear causing commercial actors to avoid the use of the special deposit. The Act eliminates this uncertainty and fear. Section 11 provides that a bank may not exercise a right of recoupment or set off with respect to a special deposit. There are certain exceptions dealing with fees associated with the special deposit, and the unusual situations where an offset is needed to remedy a mistaken credit to the balance in the special deposit account. However, the general rule is clear — there is no threat from recoupment or setoff, and the special deposit is protected.

The Act Includes Provisions Intended to Incentivize Banks to Offer a Special Deposit Product

The Act also provides some incentives for banks to offer a special deposit product. Currently, some banks do not offer a special deposit product. The Act does not alter this condition, and no bank is required to offer a special deposit. Instead, the Act provides incentives so that this safe, secure, and efficient mechanism is more widely available. First, the Act makes clear that a bank holding a special deposit owes a duty to its customers – the depositor and the beneficiary – and not to any third party. There is an unsettling trend in tort law to hold banks liable to non-customers who have been damaged indirectly either by bank action or the action of a bank customer. Second, the Act provides that the bank offering the special deposit is not liable for consequential damages. Third, the Act permits a bank to rely on records presented in accordance with the account agreement to determine payment rights, and if the bank relies on a record, the bank will have no liability if it acts in good faith on the "genuineness" of the record. Fourth, the Act clarifies that the bank has no duty to "police" whether its customer is meeting the "permissible purpose" criterion, and if the bank learns that the customer is not meeting the permissible purpose criterion, it is given discretion to take action

including closing the customer's special deposit. Finally, there is a "built-in" economic incentive for a bank to offer a special deposit, especially in an environment where demand deposits may be instantly withdrawn using an electronic instruction, as recent cases have demonstrated. A special deposit is not, as a banker would say, "run-able". It is not payable on demand; it is payable upon the occurrence of a contingency. This makes the special deposit resemble a time deposit, in that it becomes payable at a future point when the contingency is determined. A bank can perform necessary asset/liability management with a clear view of when special deposit funding will come due.

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