Common Law and Contractual Setoff
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February 28, 2019 --- It is important to understand the limitations or conditions that apply to a common law right of setoff when a borrower goes into default and the bank chooses to apply deposited funds. Illinois case law has established that: (1) the right of setoff is conditioned on "mutuality" of the identity of the accountholder(s) and the loan customer(s); and (2) the bank does not have the right to apply the accountholder's funds on deposit until the accountholder has defaulted on loan terms.

Regarding "mutuality," if a C.D. is owned by Jane Doe, and her husband John Doe defaults on a loan from the same bank, that bank has no right of setoff against Jane Doe's deposit account because the identity of the account owner and the identity of the borrower-in-default are not the same. In fact, in a 1993 Illinois Appellate Court decision, the case involved seven C.D.s on which a mother (who was the original accountholder) added three sons as joint accountholders. Subsequently, a loan taken out by the mom and one of the three sons went into default and the bank applied setoff against all seven C.D.s. The Appellate Court ruled that the bank had to return the funds in all accounts except one, because even though the co-borrower son was named as a joint owner of each C.D., there was no mutuality of parties because the other two sons who were also jointly on the C.D. accounts were ***not*** the borrowers in default. The one C.D. for which the Court ***did*** allow setoff by the bank included a signature card contractual term stating that setoff was permitted against any account on which the son was an owner; in other words, if common law "mutuality" does not exist, the only authority for setoff would be ***contractual***.

Contractual setoff in the absence of mutuality of parties was upheld in a 1994 Illinois Supreme Court decision. The facts in that case were similar to the scenario in the 1993 Appellate Court decision described in the preceding paragraph: a parent opened five C.D. accounts and

subsequently added two sons as joint owners. Although the signature card contract(s) did not address setoff, they unambiguously specified that the bank could treat any of the owners as the absolute owner of the account in his own right. When one of the sons defaulted on an ag loan, the bank applied setoff. The Illinois Supreme Court conceded that there was no mutuality of parties for common law setoff, it ruled that the common law principle could be overridden by contract, and since the signature card contracts established that each of the C.D.s was essentially individually owned by each of the owners, the C.D.s were eligible for setoff when the co-owning son defaulted on his ag loan.

The bottom line is that while common law will allow setoff if certain conditions are met, the safest play for a bank and its attorney is to include contract terms that unambiguously tie jointly-held accounts to the debt of any individual co-owner of an account.

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