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TESTIMONY OF REP. LAWRENCE R. KLEMIN SENATE BILL NO. 2123 SENATE INDUSTRY AND BUSINESS COMMITTEE JANUARY 13, 2025

Mr. Chairman and Members of the Senate Industry and Business Committee. I am Lawrence R. Klemin, Representative for District 47 in Bismarck. I am also Chairman of the North Dakota Commission on Uniform State Laws. I am here to testify in support of Senate Bill No. 2123, relating to the Uniform Special Deposits Act.

The North Dakota Commission on Uniform State Laws is established in Chapter 54-55 of the North Dakota Century Code. Under Section 54-55-04, the Commission may submit its recommendations for the enactment of uniform and model laws to the Legislative Management for review and recommendation. Attached are the recommendations of the Commission that were submitted to the interim Judiciary Committee and subsequently to Legislative Management in November 2024. This attachment lists the 11 current members of the North Dakota Commission and the four Uniform Acts introduced by the Commission this year. I am the Representative appointed by Legislative Management to represent the House of Representatives on the National Conference of Commissioners on Uniform State Laws, also known as the Uniform Law Commission (ULC). Senator David Hogue is the person appointed to represent the Senate. Both I and Senator Hogue are Life Members of the ULC, having been elected as Life Members after having served more than 20 years on the ULC.

The Uniform Law Commission (ULC) is a state-supported organization that was established in 1892 and provides states with non-partisan, well-conceived and well-drafted legislation that brings clarity and stability to critical areas of state statutory law. North Dakota joined the ULC in 1893. Since that time, North Dakota has enacted 183 uniform and model Acts, of which 80 are still currently in effect. The Acts have been subject to revision over time and some Acts have been repealed as outdated. I have also attached a list of the 80 Acts currently in effect in North Dakota so that you can see what we still have on the books.

ULC commissioners are practicing lawyers, judges, legislators and legislative staff, and law professors, who have been appointed by state governments as well as the District of Columbia, Puerto Rico and the U.S. Virgin Islands. There are more than 350 ULC

Commissioners. ULC commissioners donate thousands of hours of legal work, without compensation, to research, draft and promote enactment of uniform state laws in areas of state law where uniformity is desirable and practical.

The Uniform Special Deposits Act (the “Act”), as adopted by Senate Bill 2123, is the result of a multiyear, collaborative drafting process with input from leading experts in commercial law and the financial services industry. The Act provides clarity to an area of law that has been uncertain for a number of years.

Special deposits are banking products that have different characteristics than other deposit accounts like checking or savings deposits. One might think of this device as in the nature of a protected escrow account. Special deposits are established for a particular purpose, and a beneficiary’s entitlement to payment is determined only after a contingency has occurred. That contingency could be 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. These deposits ensure funds will be available to the person entitled to them in the future.

Special deposits serve an important function in commerce and industry. 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. Parties using a special deposit expect that, when the contingency occurs, the money will be there to pay.

While they are a vital component of our banking infrastructure, legal uncertainties have caused many to avoid using special deposits. These uncertainties thwart the parties’ expectations that funds in a special deposit will be available to them once the contingency has occurred. Historically courts have attempted to fashion protections through, among other measures, common law referring to special deposits. Case law has analogized special deposits to a trust, bailment, or custody arrangement. However, these characterizations are anachronistic in the context of modern banking and do not reflect how the special deposit is used in practice. The attributes that make a deposit “special,” that is, the rights of the parties interested in the special deposit, are also uncertain under current law.

The key objectives of Senate Bill 2123 are to: (1) preserve and protect the important functionality of the special deposit by eliminating the legal uncertainties that inhibit use; (2) honor the expectations of the parties; (3) build on existing law applicable to general deposits in the 50 states; (4) disrupt existing law as little as possible; and (5) deliver narrowly-tailored solutions to cure four problems that can frustrate the expectations of parties electing to use a special deposit.

These are the areas where the common law needs to be improved:

Identification of the Special Deposit

The Act clarifies the defining characteristics of a special, as opposed to general, deposit. Under the Act, a special deposit must be (i) designated as “special” in an account agreement governing the deposit at a bank, (ii) for the benefit of at least two beneficiaries, (iii) denominated in money, (iv) for a permissible purpose identified in the account agreement, and (v) subject to a contingency specified in the account agreement that is not certain to occur, but if it does occur, creates the bank’s obligation to pay a beneficiary. If all those characteristics are present, the deposit is a special deposit.

The requirement that the special deposit serve a permissible purpose is a crucial feature of the Act. It prevents the special deposit from being used inappropriately for fraudulent or abusive purposes—for example, to defraud or evade creditors. A permissible purpose is defined 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 future funds deposited in the account. In addition, the Act ensures that a deposit or transfer voidable under other law is not protected by designating it as a special deposit.

Bankruptcy of the Depositor

The Act also clarifies the treatment of a special deposit in the event of a depositor’s bankruptcy. Under the current law of most states, a depositor’s rights in its bank accounts upon filing a bankruptcy proceeding become vulnerable to being drawn into the bankruptcy estate. Thus, an intended special deposit of that bankrupt depositor, without the benefit of the special deposit law device, could be “swept” into the bankruptcy estate. *Markel Insurance Company v. Origin Bancorp, Inc.*, 663 F.Supp.3d 670 (ND Tex. Mar. 2023); *In re Urb. Commons 2 W. LLC*, 648 B.R. 530 (Bankr. S.D.N.Y. 2023).

For example, imagine a commercial office building where the landlord requires tenants to pre-pay rent as a security deposit. The landlord may put each tenant’s security deposit into a single, commingled account. If there is no damage to the property at the end of the lease, the security deposit is due to the tenant. If the landlord declares bankruptcy, the tenant’s security deposit could be caught up in the bankruptcy proceeding. The Act will prevent this outcome and ensure funds remain available for the tenant.

Premature Creditor Process

Third, the Act provides certainty about the applicability of creditor process on a special deposit. Under current law, there is considerable uncertainty as to whether a creditor of a debtor who is a potential payee from a special deposit may either attach the special

deposit or reach the special deposit with a temporary restraining order or injunction. After all, the identity of the ultimate beneficiary has not been determined at the time the special deposit is established because the contingency has not yet occurred. Creditor process can therefore “freeze” a special deposit and interfere with the intended purpose.

Section 6-08.6-08 provides that creditor process is not enforceable against the bank holding the special deposit, except in limited circumstances. It may well be enforceable against the bank holding a special deposit with respect to any amount that it must pay to a beneficiary after determination of the contingency, but the special deposit itself is fully protected until that contingency is determined. Section 6-08.6-09 eliminates the ability of creditors to use an injunction or temporary restraining order to achieve the same or a similar outcome.

Bank Setoffs

The Act also addresses whether the bank holding the special deposit can exercise a right of set off or recoupment that is unrelated to any payment to a beneficiary or to the special deposit itself. Section 6-08.6-10 provides that a bank may not use special deposits to satisfy unrelated debts. There are certain exceptions dealing with fees associated with the special deposit, and situations where an accounting offset is needed to remedy a mistaken credit to the special deposit account. However, the general rule is clear — there is no threat from recoupment or setoff, and the special deposit is protected.

Self-Imposed Limitations of the Uniform Special Deposits Act

The Act contains several self-imposed limitations. Importantly, the Act was drafted with a “minimalist” philosophy and addresses only specific uncertainties existing under current law. The Act does not duplicate the law governing deposits generally and, instead, alleviates the problems in existing law that cause uncertainty around special deposits. This enables the Act to operate in conjunction with existing commercial law and embraces the parties’ freedom to contract.

Another important limitation of the Act is its “opt-in” nature. The bank and its customer must elect to treat the deposit as a special deposit to be covered by the Uniform Special Deposits Act. This permits existing relationships to continue undisturbed. Parties can also amend existing agreements to be covered by the Act if the relationship satisfies the Act’s criteria to establish a special deposit.

Additionally, the Act does not address the insolvency of the bank holding a special deposit, for two reasons. First, bank insolvency law regarding special deposits is clear and well-developed. Second, bank insolvency law has largely become the product of federal law. State law, including the Act, can only perform a limited role.

Finally, the Act does not require banks to offer a special deposit product. Some banks may decide that this will not be among their offered suite of products or that they will only offer such a product under limited circumstances.

Conclusion

The Uniform Special Deposits Act is intended not to introduce new legal concepts, but rather to eliminate uncertainty that attaches to the use of special deposits under existing law and therefore help ensure that the expectations of parties entering into those transactions are met. Those are just a few benefits offered by the Uniform Special Deposit Act. Thank you for your time and consideration of this Act.

I have attached a section-by-section summary of the USPA in SB2123; a short summary of the USDA; and a document from the ULC explaining why States should adopt the USDA. I have also unloaded the complete ULC version of the Act, which includes the official comments. The USDA was approved by the ULC in 2024. I can go through the sections in detail if that is the wish of the Committee. There are also others who are here to testify in support of SB2123.

Mr. Chairman and Members of the Committee, I urge you to recommend "Do Pass" on SB2123. I would be happy to answer any questions that you may have on SB2123. Thank you.

Rep. Lawrence R. Klemin