# Commercial Paper, Bank Deposits and Collections, and Commercial Electronic Fund Transfers

*By Fred H. Miller* (with Hal S. Scott**)*

This year two major changes occur with respect to the annual survey. First, due to the formation of a new Subcommittee on Letters of Credit, the article prepared by the Subcommittee on Commercial Paper and Bank Deposits and Collections no longer covers letters of credit. That subject is included in the annual survey, but now is prepared by members of the new subcommittee.

The second change is reflected in the new title for this section of the annual survey. A great deal of law has been made in the last few years in the electronic fund transfer (EFT) area, both on the federal and on the state level, but limited to the consumer context.[1] In the commercial context, matters primarily were governed by the agreement of the parties. This is beginning to change. A major case has been decided[2] and a major project to draft statutory rules is well under way.[3] Thus, beginning with this annual survey, commercial EFT developments will be covered as a particular topic. The initial effort in this respect is written by Professor Hal S. Scott, who is the reporter for the above-mentioned drafting project.

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This survey was prepared with the assistance of other subcommittee members: Henry J. Bailey III, Christopher L. Carson, John W. Edmonds III, Stanley F. Farrar, Tom L. Holland, Edward L. Kelly, Curtis W. Nyquist, Donald J. Rapson, Johanna M. Sabol, Alan R. Sachs, Thomas J. Sherrard, William H. Smith, and Jack C. Wessler.

1. Developments in that context have been the subject of several articles in the annual surveys of consumer financial services law which also appear in The Business Lawyer. The latest is Brandel and Geary, *Electronic Fund Transfers and the New Payments Code*, 37 Bus. Law. 1065 (1982).

2. Evra Corp. v. Swiss Bank Corp. v. Continental Illinois National Bank and Trust Co. (third-party defendant), 673 F.2d 951, 34 U.C.C. Rep. Serv. 227 (Callaghan) (7th Cir. 1982), *rev'g* Evra Corp. v. Swiss Bank Corp. v. Continental Illinois National Bank and Trust Co. (third-party defendant), 522 F. Supp. 820 (1981).

3. Uniform New Payments Code being prepared under the auspices of the Permanent Editorial Board for the Uniform Commercial Code by the National Conference of Commissioners on Uniform State Laws and the American Law Institute. Both Evra Corp. v. Swiss Bank Corp., *supra* note 2, and the New Payments Code are discussed in this annual survey, *infra*.

## *COMMERCIAL ELECTRONIC FUND TRANSFERS*

Three important cases were decided in 1982 in the area of commercial electronic fund transfers. They are *Evra Corp. v. Swiss Bank Corp. v. Continental Illinois National Bank and Trust Co.* (third-party defendant) (*Evra*),[4] *Houston Contracting Corp. v. Chase Manhattan Bank, N.A.* (*Houston Contracting*),[5] and *Securities Fund Services, Inc. v. American National Bank and Trust Co. of Chicago.*[6]

In *Evra*, the Hyman-Michaels Company (Hyman-Michaels), a predecessor in interest to the Evra Corporation, brought an action against Swiss Bank Corporation (Swiss Bank) of Basel, Switzerland, for the failure of the Geneva office of Swiss Bank to promptly transmit a $27,040.62 payment order. The payment was for the account of Pandora Shipping Company (Pandora) at Banque de Paris et des Pays-Bas (Suisse) in Geneva (Bank de Paris) in accord with a telex request sent by Continental Illinois National Bank and Trust Company (Continental). Hyman-Michaels alleged breach of contract, negligence, and breach of fiduciary duty on the part of Swiss Bank. It sought expenses and lost profits due to the cancellation of a ship charter it had from Pandora, which cancellation had occurred because of the late payment. Swiss Bank impleaded Continental as a third-party defendant, claiming a right of indemnification. Continental in turn filed a cross-claim on negligence grounds against Hyman-Michaels seeking to shift back the cost of any judgment Swiss Bank might obtain against it, and Hyman-Michaels counterclaimed against Continental on grounds of negligence and breach of contract.

The district court held that Illinois law governed and that Swiss Bank had been negligent under that law. Liability to Hyman-Michaels for $2.1 million in consequential damages, consisting principally of lost profits from a subcharter of the vessel, was imposed. Swiss Bank was denied indemnification from Continental, rendering Continental's cross-claim moot. Hyman-Michaels's counterclaim against Continental was dismissed on the ground that Continental had not breached any duty to Hyman-Michaels.

Swiss Bank appealed to the Seventh Circuit from the judgment in favor of Hyman-Michaels and from the dismissal of its claim against Continental. Hyman-Michaels appealed the dismissal of its counterclaim against Continental. The Seventh Circuit reversed the Hyman-Michaels judgment against Swiss Bank and dismissed its complaint, rendering Swiss Bank's claim against Continental moot. The court affirmed the lower court's dismissal of the Hyman-Michaels counterclaim against Continental.

The case arose from the following facts. In 1972 Hyman-Michaels chartered a vessel from Pandora for one year with an option to extend the charter for a second year. Payments on the charter were due semimonthly "in advance" by

4. *Supra* note 2.
5. 539 F. Supp. 247 (1982).
6. 542 F. Supp. 323 (N.D. Ill. 1982).

deposit to Pandora's account at Bank de Paris. The charter provided that if payment was not made on time Pandora could cancel.

The first five payments in 1972 were made by wire transfer originated by Hyman-Michaels's bank, Continental. Continental debited Hyman-Michaels's account for each payment and then sent a telex to its London office for retransmission to its correspondent Swiss Bank in Geneva. Swiss Bank then advised the Bank de Paris to post a credit to its customer Pandora. Continental in Chicago settled by crediting Swiss Bank's account with it, and Swiss Bank settled by crediting the Bank de Paris account with it.[7]

Hyman-Michaels made the sixth and seventh payments by check sent to the Bank de Paris. Hyman-Michaels changed the payment method in order to have the use of its money for the period it would take the check to clear, about two weeks. The seventh payment was due at Bank de Paris on October 26, but did not arrive until October 30. Consequently, Pandora notified Hyman-Michaels that it was cancelling the charter. In fact, charter rates had risen substantially since the inception of the charter in June. The matter was referred to an arbitration panel which ruled in favor of Hyman-Michaels. The panel, however, put Hyman-Michaels on notice that the payment provision of the charter would be strictly enforced in the future.

Hyman-Michaels reverted to the use of wire transfers for the eighth through eighteenth installments. In each instance Continental Chicago sent an advice of debit to Hyman-Michaels and Continental London sent its telex instruction to Swiss Bank telex machine 22235. During this time Hyman-Michaels had subchartered its vessel to take advantage of rising rates.

At about 9:17 A.M. on April 25, 1973, Hyman-Michaels telephoned Continental and requested it to transfer $27,040.62 to Pandora's account at Bank de Paris as payment for the charter period from April 27 to May 11, 1973. Since the charter provided for payment in advance, this payment was arguably due by the close of business on April 26.[8] The requested telex went out to Continental's London office on the afternoon of April 25, which was nighttime in England. Continental Chicago issued an advice informing Hyman-Michaels that its account had been debited and that Continental was proceeding to execute the wire transfer.

At about 9:00 A.M. London time, on April 26, Continental London in accord with the instruction it had received from Chicago, attempted to telex the payment message to Swiss Bank's general telex number 22235, the number of a machine in the cable department of Swiss Bank, but the number was busy. After trying unsuccessfully to engage this number for an hour, the Continental telex operator dialed another number, that of a machine in Swiss Bank's foreign exchange department, which it had used in the past when 22235 was engaged. Swiss Bank's machine received the message because it signaled the sending machine at both the beginning and end of the transmission that the telex was

7. Telephone interview with John L. Conlan, attorney for Swiss Bank, Nov. 2, 1982.

8. 673 F.2d 953. The district court states in its opinion that payment was due at or before 9:00 P.M. Geneva time, on April 27. 522 F. Supp. 824.

being received. Yet Swiss Bank failed to comply with the message and no transfer of funds was made to Pandora's account at the Bank de Paris. While it is not clear what went wrong, the two most likely possibilities are that (1) the receiving telex machine had run out of paper or (2) whoever took the message out of the machine in the foreign exchange department failed to deliver it to the cable department. The machines in the foreign exchange department were operated by junior foreign exchange dealers rather than professional telex operators, although Swiss Bank knew that messages intended for other departments were sometimes diverted to the foreign exchange department machines.

At 8:30 A.M. Chicago time, on Friday, April 27, 1973, which was 2:30 P.M. Swiss time, Hyman-Michaels in Chicago received a telex from Pandora canceling the charter because payment had not been made. Hyman-Michaels instructed Continental by telephone to keep trying to effect payment, and confirmed this instruction by a letter dated April 28. Four days later, on Tuesday, May 1, Swiss Bank instructed the Bank de Paris to post the $27,000 credit to Pandora's account; payment was, however, refused by Pandora.

A second arbitration panel reviewed the matter and concluded that Pandora was entitled to cancel the agreement. The panel found that Hyman-Michaels had been "blameless" up until the morning of April 27, but that it had thereafter failed to try to remedy the situation. The panel stated that Hyman-Michaels "could have ordered an immediate duplicate payment—or even sent a Banker's check by hand or special messengers, so that the funds could have reached owner's Bank, not later than April 28th."[9]

Judge Posner's opinion for the Seventh Circuit begins with the question of Swiss Bank's liability to Hyman-Michaels for consequential damages in the form of lost profits and expenses amounting to $2.1 million.[10] The court observed that section 4-103(5) of the Illinois Uniform Commercial Code would preclude consequential damages for the loss of a check, absent bad faith, but concluded that the draftsmen of the Code did not intend electronic fund

9. 673 F.2d 954. Judge Posner states in his opinion for the Seventh Circuit that "Hyman-Michaels did not attempt to wire the money directly to the Banque de Paris as it had done on the occasion of its previous default." *Id.* at 953. It is unclear what the court had in mind. One possibility, however, is that Continental could have asked its own subsidiary in Zurich, which held an account of the Bank de Paris, to effect the transfer by crediting the Bank de Paris's account and notifying Bank de Paris in Geneva to credit Pandora. *See* Brief of Appellant Swiss Bank Corp., in the United States Court of Appeals for the Seventh Circuit, at 18-19. The brief recites that

> John Biella, the man responsible for Continental's international banking operations, testified that if he had been notified at 8:45 A.M. [on April 27] of the need for an urgent payment to Parisbas [Bank de Paris] it might just be possible that it could have been made before Parisbas [Bank de Paris] closed that day.

*Id.* at 19. It is also unclear how late on the 27th the Bank de Paris would actually have accepted the deposit for same-day credit to Pandora.

10. The major expenses and attorney and arbitral fees for the second arbitration proceeding were determined to be approximately $17,000 by the district court. 522 F. Supp. 835. Hyman-Michaels did not claim loss of interest because its account with Continental did not pay interest.

transfers to be covered by article 4.[11] If article 4 were applicable, directly or by analogy, its rule would therefore be that no recovery for consequential damages may be had in the case of a collecting bank like Swiss Bank. U.C.C. section 4-103(5) provides that the maximum "measure of damages for failure to exercise ordinary care in *handling an item* is the amount of the item . . ." (emphasis added). It should be noted, however, that if the Code were applicable and Continental had failed to transmit the wire to Swiss Bank, Hyman-Michaels might have been entitled to consequential damages from Continental for wrongful dishonor under U.C.C. section 4-402.[12] In this event, while there appear to be no Code cases indicating that victims of wrongful dishonor have a duty to mitigate damages, that duty should clearly be implied as a matter of common law.[13] Finally, given article 4's acceptance of the "Massachusetts Rule" in U.C.C. section 4-202(3), Continental would not have been responsible as principal for the negligence or misconduct of its agent Swiss Bank, were the Code applicable.

Having determined that the Code did not apply, the court turned to the common law on liability for consequential damages. It relied on *Hadley v. Baxendale*[14] for the proposition that "consequential damages will not be awarded unless the defendant was put on notice of the special circumstances giving rise to them. . . ."[15] Swiss Bank did not know when payment was due, what the terms of the charter were, or that they were extremely favorable to Hyman-Michaels. As the court stated, "Electronic funds transfers are not so unusual as to automatically place a bank on notice of extraordinary consequences if such a transfer goes awry."[16] While *Hadley v. Baxendale* is a contract law rule, the court thought tort law should produce the same result since "the costs of the untoward consequence of a course of dealing should be borne by that party who was able to avert the consequence at least cost and failed to do so."[17]

11. The court cited § 4-102(2) in this regard, which is a conflicts rule for determining which law governs action or nonaction of a bank with respect to handling an "item." The real issue, however, is whether the telex was an item. An item is defined in § 4-104(1)(g) as "any instrument for the payment of money even though it is not negotiable but does not include money." While some have argued that an item could include an electronic fund transfer, (see Clark, *An Item is an Item is an Item: Article 4 of the U.C.C. and the Electronic Age*, 25 Bus. Law. 109 (1969)), it is clear that these rules are not easily adaptable to credit transfers, such as wires. The court noted that Delbrueck & Co. v. Manufacturers Hanover Trust Co., 609 F.2d 1047, 1051 (2d Cir. 1979), discussed in Bailey, *Annual Survey—Commercial Paper, Bank Deposits and Collections, Letters of Credit*, 35 Bus. Law. 1129–30 (1980), had found art. 4 inapplicable and had applied common law principles instead.

12. U.C.C. § 4-402 provides that "[a] payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item." In a credit transfer, Continental should be regarded as the payor bank, "a bank by which an item is payable as drawn or accepted," U.C.C. § 4-105(b). Hyman-Michaels can be viewed as having drawn an order on Continental to pay Pandora.

13. U.C.C. § 1-103. *See* W. Prosser, Law of Torts, 4th ed., § 65, at 422–23 (1971).

14. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

15. 673 F.2d 955–56.

16. *Id.* at 956.

17. *Id.* at 957.

In this connection, the court found that Hyman-Michaels showed a lack of prudence in waiting "till arguably the last day before payment was due to instruct its bank to transfer the funds overseas."[18] It was also imprudent to fail to "pull out all the stops" to get payment to the Bank de Paris on April 27, after it learned of the cancellation. The court states that "it might have made all the difference if Hyman-Michaels had gotten payment to the Bank de Paris by April 27, or even by Monday, April 30, rather than allowed things to slide until May 2."[19] The failure to act promptly expost was in derogation of the duty to mitigate or avoid damages once an accident (loss of the telex message) had occurred.

The court wove an additional strand of tort law into its opinion. Torts provides that the "amount of care that a person ought to take is a function of the probability and magnitude of the harm that may occur if he does not take care. . . . If he does not know what that probability and magnitude are, he cannot determine how much care to take."[20] Since Swiss Bank had no banking relationship with Hyman-Michaels it could not know that severe consequences might follow from its failure to handle the telex transfer in timely fashion. Since Hyman-Michaels knew what turned on a prompt transfer, it was the proper party to insure against the loss.

Having determined that Hyman-Michaels could not recover consequential damages from Swiss Bank, the court ordered the complaint dismissed. Swiss Bank's third-party complaint against Continental and Continental's cross-claim against Hyman-Michaels were now moot. This left Hyman-Michaels's counterclaim against Continental. The court agreed with the district court that Hyman-Michaels did not prove its case. It stated that

> Continental did not break any contract with Hyman-Michaels. All it undertook to do on April 25 was to transmit a telex message to Swiss Bank, and it did so. All it undertook to do on April 27 . . . was to advise its correspondent—that is Swiss Bank—to "persist in attempting to make . . . payment" and it did so advise its correspondent.[21]

18. *Id.* at 957. This would be the case if payment had been due on April 26.

19. *Id.* The court read the second arbitration decision as indicating that the panel might have ruled for Hyman-Michaels if it had acted promptly to put Pandora in good funds.

20. *Id.* at 958.

21. *Id.* at 960. Since the court did not find that Continental was negligent, it did not reach the question whether the exculpatory language on its advice form protected it from liability for negligence. The clause provided as follows:

> It is fully understood and agreed that no liability shall attach to the Continental Illinois National Bank and Trust Co. of Chicago (hereinafter referred to as Bank), nor its correspondents, for any loss or damage occasioned by delay in, failure of, or error in cable, telegraph, or telex transmission of messages, or error in identification of payee, or by acts or omissions of correspondents or agencies employed by the Bank, or for any cause beyond Bank's reasonable control.

522 F. Supp. at 832 n.8.

*Evra* is an important case. The prospect of consequential damage liability for correspondent banks on wire transfers, after the district court decision, sent a chill through the banking community.[22] While the Seventh Circuit decision should allay that community's worst fears, it does not represent salvation.

While the U.C.C. strictly limits consequential damage liability for banks collecting checks,[23] the Seventh Circuit's opinion makes that liability for banks processing wire transfers turn on the particular facts of a case. The court's analysis suggests that if Hyman-Michaels had allowed more time for the wire transfer to be completed, or if it had tried harder to mitigate the consequences of the lost telex, and failed, consequential damage liability might have been imposed on Swiss Bank. The same result might have been reached if Hyman-Michaels had notified Swiss Bank of the importance of a timely transfer. Under the U.C.C., prudence exante, mitigation expost, and notice of special facts would all be irrelevant because of the limitation on recovery of consequential damages. The banks will have to live for the time being with the common law case-by-case approach.

The question of payor bank liability remains for future determination. While the Seventh Circuit determined that Continental was not negligent, and did not reach the consequential damage issue, a different result might be reached on other facts. There is also cause for concern because the district court viewed Continental's exculpatory clause in its advice form as being similar to an adhesion contract and refused to give it effect. The U.C.C. holds a payor bank

The district court had reserved judgment as to the validity of the form, which is likened to an adhesion contract. It found only that "there is no evidence that Hyman-Michaels was aware of or accepted that provision of the contract." *Id.* Since the district court determined that Swiss Bank was liable to Hyman-Michaels, it had to rule on Swiss Bank's cross-claim against Continental, which it denied under Illinois joint tort-feasor law. In particular it found that Continental's actions subsequent to April 27 were irrelevant. *Id.* at 831. The court believed that its holding on the Swiss Bank cross-claim also disposed of the Hyman-Michaels counterclaim against Continental. *Id.* at 832.

22. This is underscored by the fact that the New York Clearing House Association and the American Bankers Association filed a brief as amicus curiae on appeal. The brief stated that "[w]hether banks can continue to make EFT services available on a widespread basis, by charging reasonable rates, depends on whether they can do so without incurring unlimited consequential risks. Certainly, no bank would handle for $3.25 a transaction entailing potential liability in the millions of dollars." Brief at 15.

23. Section 4-103(5), read literally, does not preclude recovery of consequential damages from a collecting bank. It rather limits recovery of damages to the amount of the item. Where a party loses the principal amount of a check, as where a stale check is paid, or there is a failure to provide timely notice of dishonor (see Charles Ragusa & Son v. Community State Bank, 360 So. 2d 231, 24 U.C.C. Rep. Serv. (Callaghan) 725 (La. App. 1978); Colorado Nat'l Bank v. First Nat'l Bank & Trust Co., 459 F. Supp. 1366, 27 U.C.C. Rep. Serv. (Callaghan) 176 (W.D. Mich. 1978), further consequential damages are effectively precluded, but there may be no loss of principal. Under this analysis, if § 4-103(5) were applied by analogy to the facts of *Evra*, Swiss Bank would be liable for $27,040.62, the amount of the ill-fated telex transfer, and the court is technically incorrect in stating that art. 4 "precludes consequential damages unless the bank is acting in bad faith." 673 F.2d 955. Under the Uniform New Payments Code, discussed *infra*, consequential damages would be precluded even if they were less than the amount of the order.

strictly liable for wrongful dishonor of its customer's order. Negligence is irrelevant. On the other hand, the U.C.C. legitimizes a broad range of exculpatory agreements between a bank and its customer under U.C.C. section 4-103(1). While the Code does not permit banks to disclaim liability for failure to exercise ordinary care or to limit the damages for such failure, it does permit agreements to determine the standards by which such responsibility is to be measured if the standards are not manifestly unreasonable. Arguably the Code would legitimate certain agreements that courts otherwise would regard as adhesive in nature and of no effect.

Certain weaknesses in the analysis of the Seventh Circuit deserve comment. There is a logical inconsistency in the court's tort analysis of Swiss Bank's liability. If the court is correct in determining that Swiss Bank could not be liable for consequential damages, due to the unforeseeability of the risk, the action of Hyman-Michaels exante and expost should be irrelevant. Even if Hyman-Michaels had allowed more time for the transfer and/or tried to mitigate the consequences of the failed telex, Swiss Bank would still not have had notice of special facts. If the court had taken the U.C.C. approach, this inconsistency would have been avoided. Also, assuming that Hyman-Michaels's behavior is relevant, the court's conclusion that it should have allowed more time for the transfer and that it failed to mitigate damages is not fully convincing on the facts of the case. Finally, the conclusion that Continental was not negligent is not free from doubt. Hyman-Michaels ordered Continental to effect payment on the morning of April 27. While the Seventh Circuit states that it attempted to do so, the facts cited in the opinion of the district court[24] indicate that Continental spent precious hours on April 27 investigating what happened rather than carrying out its customer's order.

In concluding the discussion of *Evra*, it should be noted that the Uniform New Payments Code (NPC)[25] would apply to wire transfers as well as all other forms of payment except for cash. At present, the NPC would extend and modify the U.C.C. rules discussed for checks to wires. It provides that correspondents could not be liable for any consequential damages for the failure to correctly handle an order for payment but payors could be so liable if they dishonored an order of their customer. Mitigation expost, or prudence exante on the part of the originator of the transfer, or knowledge of special facts, would be irrelevant to consequential damage liability for a correspondent. Payors would have the same broad authority now allowed by U.C.C. section 4-103(1), however, to limit liability by contract. Thus, the NPC would produce the same result as in *Evra*, but through a much different approach.

In another case of note, *Houston Contracting Corp. v. Chase Manhattan Bank, N.A.*,[26] the Houston Contracting Corporation (Houston) brought an action against the Chase Manhattan Bank, N.A. (Chase) and Bank Tejarat, the Iranian successor-in-interest to the Iranians' Bank (Iranians') to recover

24. 522 F. Supp. 825-26.
25. *Supra* note 3.
26. 539 F. Supp. 247 (1982).

$300,000 in damages allegedly due to the failure by Chase to comply with Iranians' telexed instructions to transfer $300,000 to Houston. The court held, on cross-motions for summary judgment, that Chase was not liable to Houston under section 4-302 of the New York Uniform Commercial Code.

Iranians' was informed by Chase in September 1979 that it would not be permitted to overdraft its account. On November 11, 1979, Chase received a telex from Iranians' ordering Chase to pay $300,000 to Houston's account at First National Bank of Houston (FNB Houston). On November 13 (November 12 was a bank holiday) Iranians' balance at Chase was $12,835.98. The balance was the same when the account was blocked by executive order 12170 on November 14, which froze all Iranian accounts in response to the holding of the American hostages. Chase did not pay Houston. Instead it held over the transaction for insufficient funds. Chase did not communicate with either Houston or Iranians' on either November 13 or 14, 1979, concerning the payment order. It finally cancelled the order on February 5, 1980.

U.C.C. section 4-302 provides that if an "item" is presented on a payor bank, the bank is accountable for the amount of a *demand item*, whether properly payable or not, if the bank does not "pay or return the item or send notice of dishonor until after its midnight deadline." Houston argued that under U.C.C. section 4-302, Chase had failed to either pay the item, by transferring funds to Houston at FNB Houston, or send a notice of dishonor to Iranians', its customer,[27] by its midnight deadline, midnight November 14,[28] and was thus accountable to Houston for the amount of the order.

While the district court, unlike the Seventh Circuit in *Evra*, found that an unsigned telex was an "item" under article 4, it further held that the telex was not a "demand item" and thus was not subject to the accountability rule of section 4-302. The term demand item is not defined in the Code. In the court's view, only negotiable instruments as defined by U.C.C. section 3-104, such as checks and drafts payable on demand, qualified as demand items. The court stated that to hold otherwise "would alter well-settled obligations, blur the well-defined distinctions developed under the U.C.C., and potentially disrupt the smooth rapid functioning of commercial banking transactions which is a principal purpose underlying article 4 of the U.C.C."[29]

Even if the court correctly decided that U.C.C. section 4-302 was inapplicable, it might have applied the provisions of the section by analogy as a matter of common law.[30] Clearly, banks have some obligation to either follow the instructions of their customers ordering immediate payment or notify them that they are not going to do so. It is possible that if Iranians' had known before midnight

27. *See* U.C.C. § 3-508.

28. U.C.C. § 4-104(1)(b) defines the midnight deadline as "midnight on the next banking day following the banking day on which the bank receives the item." Since November 11 was a Sunday and November 12 was a banking holiday, the day of receipt was November 13.

29. 539 F. Supp. 249.

30. It appears, however, that the parties stipulated that the case should only be decided under § 4-302. Stipulation of Facts, ¶ C2, Sept. 29, 1981.

November 14 that its order had not been honored due to lack of funds, it might have transferred funds to Houston by other means.

The Uniform New Payments Code, as currently drafted, also does not apply the principle of U.C.C. section 4-302 to pay orders such as telexes and other wire transfers. However, the reason is because the deferred posting rationale of that section only appears applicable to collection orders presented by a bank on behalf of the payee, or its transferee, to the payor bank, as in the case of checks. On a pay order such as a telex, the payee should have no claim on the order until it has notice of the order, and no accountability should exist until the payee is advised of or actually receives a payment transfer. The NPC, nonetheless, does require that a notice of dishonor be given by a payor bank before its midnight deadline.

The last case, *Securities Fund Services, Inc. v. American National Bank and Trust Co. of Chicago*,[31] raises significant issues regarding liability for unauthorized wire transfers. An impostor ordered Security Fund Services (SFS), the shareholder service agent for the Templeton Growth Fund, to redeem $2 million worth of shares held by Mr. Bushman as trustee, and to wire the proceeds to account number 204471 at American National Bank and Trust Company of Chicago (ANB). This was accomplished by a written instruction from the impostor forging Bushman's signature. SFS directed New England Merchants National Bank (NEMB), the Templeton Growth Fund custodian, to make the transfer to the account of "John Bushman, trustee // 204471." NEMB sent this instruction, with the name and account number, to ANB. ANB credited account number 204471 even though the party named on the account was one Haberkorn. Haberkorn had previously agreed to sell approximately $2 million worth of diamonds and jewels to two individuals, one of whom was apparently the impostor,[32] who promised to pay by wiring funds to Haberkorn's account at ANB. After the transfer of funds, Haberkorn delivered the merchandise to the two individuals. Neither the funds nor the jewels were recovered.

SFS, upon discovery of the fraud, reissued the previously redeemed shares to Bushman, paying cash to Templeton for the shares. SFS sued ANB, contending it had succeeded to Bushman's and Templeton's rights. Upon ANB's motion to dismiss, the court refused to dismiss certain claims.

SFS contended that ANB acted negligently in crediting an account where the name and number did not match. The court held that SFS could be "deemed to be a 'customer' " of ANB, under U.C.C. section 4-104(1)(e). Since "ANB was acting essentially as a collecting bank for NEMB which in turn was the custodial agent of the funds disbursed by SFA,"[33] ANB owed SFS a duty to use due care in handling the wire transfer under U.C.C. section 4-203. SFS also claimed that ANB failed, as the agent of SFS, to act in accordance with the instructions of its principal. The court characterized ANB as a "collecting

31. 542 F. Supp. 323 (N.D. Ill. 1982).
32. SFS Complaint ¶ 17, filed Feb. 2, 1981.
33. 542 F. Supp. 327.

bank" under U.C.C. section 4-105(d), and under U.C.C. section 4-201(1) ANB was the agent of SFS and owed it a duty of care. In addition, the court upheld SFS's claim that it was a third-party beneficiary to the contract breached by ANB in failing to properly deliver the funds as directed by NEMB.

While the facts and theories remain to be developed in the case, one should not lose sight of the fact that SFS debited Bushman's account on an unauthorized wire transfer instruction. Also, a significant policy issue arises whether account numbers should control inconsistent names on wire transfers.[34] An opposite conclusion could pose significant operational problems for banks processing such orders by machine and greatly increase wire transfer returns where the party named in the wire does not exactly match the name on the numbered account.

## *CHOICE OF LAW*

Even though the provisions of articles 3 and 4 of the U.C.C. have been enacted in substantially uniform form in all states and for the District of Columbia and the Virgin Islands, choice of law questions continue to arise in the commercial paper context. By and large the questions usually concern whether the U.C.C. choice of law rule should apply to an issue that is not governed substantively by the U.C.C. or, if the federal government is a party to the instrument, whether the federal common law should reflect the U.C.C. rule.

On the latter question, the overwhelming authority is that the federal common law of commerce should reflect the U.C.C. rule.[35] In the area of negotiable instruments, however, there is some division of opinion.[36] Apparently, the issue was not even raised in *A.C. Davenport & Son Co. v. United States*.[37] In that case, Davenport was to supply goods to *A*, who had a contract to resell them to the General Services Administration. Under an arrangement agreed to by all parties, checks in payment were to be made payable to *A* and Davenport, and were to be sent to *A* but in care of Davenport. Davenport would then indorse for both under authority given by *A*, and deposit the checks in a special account controlled by it.

Nonetheless, for reasons best known to it, the United States sent several checks directly to *A*. When Davenport notified the United States that it had not

34. *Compare* U.C.C. § 3-118(c)(provides that "[w]ords control figures except that if the words are ambiguous figures control").

35. *See, e.g.*, United States v. Kimbell Foods, Inc., 440 U.S. 715, 26 U.C.C. Rep. Serv. (Callaghan) 1 (1979), discussed in Schimberg, *Annual Survey-Secured Transactions*, 35 Bus. Law. 1165, 1166-69 (1980).

36. *Compare* United States v. Philadelphia Nat'l Bank, 304 F. Supp. 955, 6 U.C.C. Rep. Serv. (Callaghan) 1171 (E.D. Pa. 1969) and Federal Deposit Ins. Corp. v. Kucera Builders, Inc., 503 F. Supp. 967, 31 U.C.C. Rep. Serv. (Callaghan) 606 (N.D. Ga. 1980), discussed in last year's survey in Miller, *Annual Survey-Commercial Paper, Bank Deposits and Collections, and Letters of Credit*, 37 Bus. Law. 973-74 (1982), *with* Bank of America Nat'l Trust and Sav. Ass'n v. United States, 552 F.2d 302, 27 U.C.C. Rep. Serv. (Callaghan) 1101 (9th Cir. 1977) and United States v. First Nat'l Bank, 263 F. Supp. 298, 4 U.C.C. Rep. Serv. (Callaghan) 89 (D. Mass. 1967).

37. 34 U.C.C. Rep. Serv. (Callaghan) 198 (N.D. Ill. 1982).

received any checks, a stop order was placed on the issued checks and duplicate checks were sent to Davenport. These new checks were collected and paid. Unfortunately, the earlier checks also were paid to *A*. Subsequently *A* appeared to be a poor source for recovery, so the United States claimed recovery from Davenport.

Illinois had a substantial number of contacts with this series of events and the court, pursuant to U.C.C. section 1-105, applied Illinois law.[38] Clearly the court should have applied federal common law as the checks were commercial paper issued by the United States.[39] Whether the failure to do so is significant is a harder question. Under the Illinois U.C.C., Davenport was held to be a holder in due course and not to have dealt with the United States, and thus was free of its claim for recovery. Although it could be argued that as a policy matter a federal common law rule should be different so as to throw the loss on a party to the transaction rather than upon the taxpayers, several cases suggest the federal rule should follow the U.C.C. rule in this context.[40]

The second choice of law question, whether the U.C.C. choice of law rule should apply to an issue that is not substantively governed by the U.C.C. but which arises in a commercial paper context, is likewise the subject of some debate. One case decided in the period covered in this year's survey raises this question. In *First Nat'l Bank v. Whaley*,[41] the court was of the opinion that the issue of which state law controlled the validity of a provision in a note for the payment of attorney's fees, should be decided by the conflicts rule of the forum, without reference to U.C.C. section 1-105.[42]

A case discussed in last year's survey, *Western Auto Supply v. Craig*,[43] also raises this question. There the court reached the opposite result with regard to a usury issue.[44] *Craig* involved an allegedly usurious note under the law of Alabama. It apparently was not usurious in Missouri, a state which had substantial contacts with the transaction and whose law had been selected by the parties to be applicable by an agreement in the note. The court applied the

38. U.C.C. § 1-105(1) in part specifies that, failing a valid agreement on choice of law, "this Act applies to transactions bearing an appropriate relation to this state."

39. Clearfield Trust Co. v. United States, 318 U.S. 363 (1943).

40. In United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979), the suggested policy argument in an art. 9 priority context was not found to be persuasive. Even more closely in point is United States v. First Nat'l Bank, 263 F. Supp. 298 (D. Mass. 1967), where the United States was denied recovery of payment under a common law rule modeled on the U.C.C. rule of finality of payment in favor of a holder in due course (U.C.C. § 3-418), even though the person paid was not a holder in due course of a negotiable instrument.

41. 32 U.C.C. Rep. Serv. (Callaghan) 1149 (W. Va. 1981).

42. The U.C.C. does not address the validity of a provision for the payment of attorney's fees except to provide that it will not render the sum of an instrument uncertain. U.C.C. § 3-106(1)(e) and (2).

43. 30 U.C.C. Rep. Serv. (Callaghan) 1206 (S.D. Ala. 1981).

44. *See* Miller, *Annual Survey—Commercial Paper, Bank Deposits and Collections, and Letters of Credit*, 37 Bus. Law. 973-74 (1982). The survey discussion only pointed out that commercial parties often will be allowed to contract on choice of law with respect to the usury issue, but that consumers' "agreements" in this respect often will not be binding.

choice of law rule in U.C.C. section 1-105[45] to the usury issue, even though in the U.C.C. does not legislate on the usury question.[46]

There are other cases which arguably support the result reached by the court in the *Craig* case. For example, in *In re Coyer,*[47] a note providing for charges in excess of those allowed in Maine was executed by a Maine resident and delivered to a Kentucky lender. The note provided it was to be controlled by Kentucky law. The court did not determine that U.C.C. section 1-105 could not govern the validity of the charge provision; it simply held that, as a matter of interpretation, the choice of law provision was not intended to select Kentucky law as to enforceability. Arguably better drafting would have prevented the court from concluding that the rule of section 1-105 was inapplicable to the choice of law question.[48] However, there are cases that do seem to conclude that section 1-105 is not directly applicable on a usury issue in a transaction otherwise controlled by the U.C.C.[49]

All Subcommittee members and others who entered into the debate finally agreed that section 1-105 should not be considered as directly controlling, and should be considered by analogy, if at all. This writer believes that it arguably would be sound policy to extend the uniformity goal of the U.C.C. beyond uniform substantive provisions to uniform choice-of-law rules, at least for issues that arise in the context of commercial paper like usury and provisions for attorney's fees. However, in the final analysis the language of section 1-105 suggests that this larger scope for the provision was not intended, and in many instances the question is likely to be moot, either because of a specific overriding statute[50] or because the court, applying common law, chooses the same approach as that of the U.C.C.

## *COMMERCIAL PAPER AND BANK COLLECTIONS*

### *FORM AND TERMS OF THE INSTRUMENT*

The form of an instrument is important. To promote the free transferability of commercial paper, the terms of the instrument must be easily determined. It is for this reason that U.C.C. section 3-104 (as supplemented by later provisions) contains rather rigid form requirements. Many benefits flow in the case of an instrument that fits the requirements, including freedom from most claims and defenses for a bona fide purchaser for value of the instrument who takes

45. U.C.C. § 1-105(1) allows the parties to agree on choice of law when the transaction bears a reasonable relation to both jurisdictions.

46. *See, e.g.,* U.C.C. § 3-106(1)(a), (2).

47. 6 U.C.C. Rep. Serv. (Callaghan) 869 (D. Me. 1969).

48. The result would not have changed, however, in that the court believed the applicable Maine statute would override any choice-of-law agreement that permitted excess charges. This was the point being made in connection with the *Craig* case in last year's annual survey. *See supra* note 44.

49. *See, e.g.,* Gamer v. duPont Glore Forgan, Inc., 65 Cal. App. 3d 280, 135 Cal. Rptr. 230, 25 U.C.C. Rep. Serv. (Callaghan) 550 (1976).

50. As in Uniform Consumer Credit Code § 1-201, for example.

delivery of it without notice,[51] a simplified procedural burden for recovery upon the instrument,[52] and a greater obligation than in ordinary contract by assignors of the contact the instrument represents.[53] These benefits do not necessarily attach to an instrument which does not qualify for inclusion under article 3, and thus is governed by ordinary contract law. In that case, the applicable law may be quite different.

Each year cases arise which reflect a failure to understand this basic concept. Several of them, all on the same point, are worth mention this year.[54] Each case involved a contract of guaranty separate from a note, and which did not meet the requirements of U.C.C. section 3-104 in that the guaranty specified no amount of liability but merely a limitation on aggregate liability.[55] In each case, the court held that article 3 was not the governing law.[56]

The principle that the terms of a negotiable instrument be certain also leads to difficult questions with respect to the application of the parol evidence rule to commercial paper. Since the instrument only represents the payment aspect of the underlying transaction and not all of its provisions, those provisions often are offered to qualify the payment obligation. Under the Code, parol evidence may not be used to contradict the terms of the instrument. Two cases decided within the period covered by this year's annual survey so hold.[57] In *Evenson v. Hlebechuk*[58] the court refused to admit unwritten parol evidence that attempted to establish a condition to an unconditional promise to pay in an unambiguous note which allegedly grew out of an agreement contemporaneous with the instrument. And in *Main Bank v. Baker*,[59] where the note clearly obligated its makers to make monthly payments until the note was paid, the admissibility of evidence of oral agreements, making the receipt of lease payments a condition to the note payments, was denied.[60]

51. U.C.C. §§ 3-302(1), 3-305.

52. U.C.C. § 3-307.

53. U.C.C. § 3-414(1).

54. They are Halpin v. Frankenberger, 644 P.2d 452, 34 U.C.C. Rep. Serv. (Callaghan) 189 (Kan. 1982); Chemical Bank v. Pic Motors Corp., 452 N.Y.S.2d 41, 34 U.C.C. Rep. Serv. (Callaghan) 219 (N.Y. Sup. Ct. 1982); and Gillespie v. DeWitt, 280 S.E.2d 736, 32 U.C.C. Rep. Serv. (Callaghan) 480 (N.D. App. 1981).

55. This is not a "sum certain" required by U.C.C. §§ 3-104, 3-106.

56. In Halprin v. Frankenberger, 644 P.2d 452, for example, this determination rendered U.C.C. § 3-606 inapplicable to discharge a guarantor where the holder of the note had released collateral for the debt without the consent of the guarantor. In First Nat'l Bank v. Bennett Venture, Inc., 32 U.C.C. Rep. Serv. (Callaghan) 505 (Ariz. App. 1981), however, the court did not seem to recognize that U.C.C. § 3-606 did not apply to a continuing guaranty which was not a part of the negotiable instrument. The court relied on a waiver in the guaranty to find the guarantor was not discharged. Probably the same result would be reached outside the Code on the facts of the case.

57. U.C.C. § 3-119(1) states that, as between the immediate parties or between a transferee of the payee and the obligor, a *written* agreement executed as part of the same transaction may modify or affect the instrument.

58. 305 N.W.2d 13, 32 U.C.C. Rep. Serv. (Callaghan) 154 (N.D. 1981).

59. 427 N.E.2d 94, 32 U.C.C. Rep. Serv. (Callaghan) 470 (Ill. 1981).

60. A consistent result was reached by the court in Reichhold Chemicals, Inc. v. Replex Corp., 401 So. 2d 96, 31 U.C.C. Rep. Serv. (Callaghan) 1657 (Ala. Civ. App. 1981). In that case, the

At times, however, the argument is made that the parol evidence shows delivery of the instrument for a special purpose or otherwise bears on whether any obligation arose, as opposed to contradicting an obligation that did come into being.[61] This argument was successful in *Labar v. Cox*,[62] but failed in *First International Bank of Israel, Ltd. v. L. Blankstein & Son, Inc.*[63] In the latter case, the court decided that a note, delivered to be held as collateral for future performance, was subject only to a condition subsequent, which could not be shown to defeat liability. A dissent read the evidence to raise a condition to the note becoming binding, and so thought the holder in due course issue should have been tried.[64] This indicates the fine distinctions that the parol evidence issue may involve.

## *NEGOTIATION*

Negotiation is a concept of importance primarily because it is necessary to holder in due course status.[65] That status of course is significant because it enables the holder of an instrument to take it free of claims and most defenses to its payment.[66] As bearer paper[67] is seldom in circulation, in most instances negotiation requires delivery of the instrument and the indorsement of the person making delivery.[68] In the case of a check taken by a depositary bank for collection, U.C.C. section 4-205(1) permits the bank to supply its customer's indorsement necessary for title, unless the instrument by its terms provides otherwise.

In *Marine Midland Bank, N.A. v. Price, Miller, Evans & Flowers*,[69] a bank took an unindorsed check, stamped it "Credit to the account of the payee herein named/Marine Midland Chautauqua Bank" even though the person had no account and the bank was essentially cashing the check, and then wired funds in the amount of the check to a designated person. It later became important for the bank to be a holder in due course. The majority of the court held that holder in due course status was permitted under the stamp the bank had placed on the check pursuant to the second sentence of section 4-205(1), which provides that

court refused, absent fraud or misrepresentation, to admit evidence tending to show that a guarantor of notes did not understand he would be liable and was not so informed when the guarantee on the notes was unambiguous.

61. The argument will not be available if the holder of the instrument is a holder in due course. *Compare* U.C.C. § 3-305 *with* § 3-306(c).

62. 635 S.W.2d 801, 33 U.C.C. Rep. Serv. (Callaghan) 1397 (Tex. App. 1982).

63. 449 N.Y.S.2d 737, 33 U.C.C. Rep. Serv. (Callaghan) 1422 (N.Y. Sup. Ct. 1982).

64. *See supra* note 61.

65. U.C.C. § 3-302(1).

66. U.C.C. § 3-305.

67. Bearer paper is an instrument originally made to bearer or some nonspecific payee like "cash" (U.C.C. § 3-111), or that is indorsed in blank (U.C.C. § 3-204(2)). Bearer paper is negotiated by delivery alone. U.C.C. § 3-202(1).

68. U.C.C. § 3-202(1).

69. 446 N.Y.S.2d 797, 32 U.C.C. Rep. Serv. (Callaghan) 1162 (N.Y. Sup. Ct. 1981), *rev'd on other grounds*, 441 N.E.2d 1083, 34 U.C.C. Rep. Serv. (Callaghan) 1207 (N.Y. Ct. App. 1982).

"a statement placed on the item by the depositary bank to the effect that the item was deposited by a customer or credited to his account is effective as the customer's indorsement." The dissent disagreed, indicating the bank had not argued the stamp was an indorsement but instead had argued that it obtained holder status without indorsement because of section 4-205(1),[70] and that, in any event, the stamp was an inappropriate indorsement.

Subcommittee members are not in agreement on the case either. On balance, a good argument may be made that the decision is correct. While an instrument taken for security may fall without section 4-205,[71] whether provisional credit or cash is given seems irrelevant under article 4.[72] Nor do the words of the stamp seem crucial enough to cause a variance in result.

A necessary indorsement is important for another reason. If a necessary indorsement is unauthorized or missing, subsequent parties dealing with the instrument may be responsible to the drawer or to the person who, by failure of indorsement, still retains an interest in the instrument.[73] This point was the basis for suit in *American Nat'l Bank v. Seidel.*[74] In that case, a not very creditworthy company sought a loan. The bank was agreeable if the principals of the company also would be responsible. The transaction took the form of a loan to the two principals, and the wife of one of them who also was included as a signer of the note. In fact, her signature was forged, both on the note and on the check that represented the loan proceeds. Later, in an attempt to shift the loss, improper payment of the check was asserted. The court held that as the wife was not intended to have a real interest in the check, her indorsement was not necessary and was legally effective.[75] While this may be a correct holding for purposes of the Code, it might be noted that the finding on which it is based indicates that the lending bank probably violated the federal Equal Credit Opportunity Act.[76]

70. A much criticized case so holding is Bowling Green, Inc. v. State St. Bank & Trust Co., 425 F.2d 81, 6 U.C.C. Rep. Serv. (Callaghan) 1151, 7 U.C.C. Rep. Serv. (Callaghan) 635 (1st Cir. 1970). A case to the contrary is United Overseas Bank v. Veneers, Inc., 375 F. Supp. 596, 14 U.C.C. Rep. Serv. (Callaghan) 1349, 1364 (D.C. Md. 1973). On appeal (441 N.E.2d 1083) the appellate court specifically rejected the argument of the bank based on the *Bowling Green* case. Holder in due course status was denied, however, as the bank had not followed the indorsement it had supplied.

71. Security Pac. Nat'l Bank v. Chess, 58 Cal. App. 3d 555, 19 U.C.C. Rep. Serv. (Callaghan) 544.

72. U.C.C. § 4-201(1).

73. *See, e.g.,* U.C.C. § 3-419 on the latter point.

74. 622 S.W.2d 19, 32 U.C.C. Rep. Serv. (Callaghan) 891 (Mo. App. 1981).

75. U.C.C. § 3-405(1)(b).

76. 12 C.F.R. § 202.7(d) (regulation B) under that Act prohibits automatically requiring the signature of an applicant's spouse or other person on a credit instrument.

## RECOVERY UPON THE INSTRUMENT

### Holder Status

Under U.C.C. section 3-301, generally only a holder of the instrument has rights upon it. A rather novel argument was advanced in an attempt to obtain holder status in *Becker v. Nat'l Bank & Trust Co.*[77] There the payee of notes transferred them without indorsement.[78] The notes contained a provision that the payee or its assignee could freely assign or negotiate the instruments. The argument was made that this provision constituted an agreement of the parties which, pursuant to U.C.C. section 1-102(3), could vary the effect of the Code's requirements for holder status. The court properly recognized that accepting this argument would be tantamount to permitting the parties to an instrument to bring it within article 3 even though it did not meet the form requirements of U.C.C. section 3-104. As the Code is very clear this is not permissible,[79] the court denied holder status.

Holder status under article 3 entitles one to recover on the instrument unless a signature necessary to liability is in issue or some other defense is established.[80] This rule, which is quite different from the ordinary contract law rule, was emphasized in two opinions worth noting this year. In both *Tuttle v. Rose*[81] and *Leopold v. Halleck,*[82] the Illinois court held that where an instrument prima facie coming within article 3 as to form, was produced, was payable to the claiming party, and where execution was admitted, recovery was warranted. Thus, delivery, nonpayment, consideration, and holder status need not be alleged or proven absent the establishment of a defense.

### Defenses to Recovery

#### *Signature in a Representative Capacity*

The proper way to sign in a representative capacity and thus make the organization represented liable and avoid personal liability on an instrument is to write the name of the organization preceded or followed by the representative's name and office.[83] Notwithstanding this simple rule, again during the survey period this year numerous cases involve the issue whether a person, who later alleges a signature was made in a representative capacity even though the form is incorrect, is personally liable.

77. 32 U.C.C. Rep. Serv. (Callaghan) 1083 (Va. 1981).

78. U.C.C. § 4-205(1) would not be applicable as the notes were not taken for collection. As the notes were not bearer, the indorsement of the payee was necessary. U.C.C. § 3-202(1).

79. Comment 2 to U.C.C. § 1-102 and comment 2 to U.C.C. § 3-104.

80. U.C.C. § 3-307(2).

81. 430 N.E.2d 356, 33 U.C.C. Rep. Serv. (Callaghan) 305 (Ill. App. 1981).

82. 436 N.E.2d 29, 33 U.C.C. Rep. Serv. (Callaghan) 1401 (Ill. App. 1982).

83. U.C.C. § 3-403(3). A case apparently illustrating the proper method of signature is Barclay v. Epic Associates XXIV, 33 U.C.C. Rep. Serv. (Callaghan) 1015 (Tex. App. 1982) (note signed with name of business followed by individual name and designation of office).

As long as the instrument names the person represented, even if representative capacity is not shown, or shows representative capacity even if the person represented is not named, parol evidence is admissible between the immediate parties to show there was no agreement for personal liability. In *Wurzburg Bros., Inc. v. Coleman,*[84] the court correctly determined that the person represented could be named anywhere on the face of the instrument and did not have to be named in connection with the signature. Thus an individual shareholder escaped personal liability when the note recited the corporation promised to pay. Nonetheless, on similar facts, the court in *Kuhns v. Coussement*[85] found the president of a corporation personally liable when he signed a note in which the corporation promised to pay but where his signature did not evidence his representative capacity. The reason was that the parol evidence that he intended to sign as a corporate officer and that the debt was a corporate debt was not considered by the court to be conclusive. The court stated the necessary showing was that the other party knew the signer was signing in a representative capacity. Moreover, the court found parol evidence that corporate checks for installment payments previously had been accepted did not suffice, since this did not involve previous transactions establishing a course of dealing involving an understanding of no personal liability.

The same evidentiary point is illustrated by two cases where representative capacity was shown. In *Maine Gas & Appliances, Inc. v. Siegel,*[86] the court admitted parol evidence where the note was signed with the name of a corporation followed by an individual name preceded by the word "by." However, in *Legg v. Kelly,*[87] on similar facts personal liability was found in the absence of any parol evidence being offered. Moreover, in *Phenix Girard Bank v. Cannon,*[88] where the note was similarly signed but, in addition, the same individual signed again on the next line which had the word "debtor" under it, the court concluded, as a matter of law, that the individual was personally liable under U.C.C. section 3-403(2)(a). The court said the last signature neither named the person represented nor showed representative capacity.

*Dalton v. George B. Hatley Co., Inc.*[89] is worth mention in conclusion. The case applies the rules of section 3-403 in a somewhat unusual context. Company *A* agreed to guarantee a note for *D*. The note was signed by *D* as maker, and by the president of company *A*, but in his own name without any indication of the company or his title in the company. When *D* defaulted, company *A* paid the note and took possession of it. Company *A* then brought suit. The court made short work of *D*'s lack of gratitude in denying liability, holding that (1) the guarantor was an accommodation maker, (2) there thus was a right of recourse under U.C.C. section 3-415(5), and (3) while company *A* could not be the

84. 404 So. 2d 334, 32 U.C.C. Rep. Serv. (Callaghan) 182 (Ala. 1981).
85. 412 So. 2d 783, 33 U.C.C. Rep. Serv. (Callaghan) 1406 (Ala. 1982).
86. 438 A.2d 888, 32 U.C.C. Rep. Serv. (Callaghan) 1534 (Me. 1981).
87. 412 So. 2d 1202, 33 U.C.C. Rep. Serv. (Callaghan) 1412 (Ala. 1982).
88. 414 So. 2d 926, 33 U.C.C. Rep. Serv. (Callaghan) 1419 (Ala. 1982).
89. 634 S.W.2d 374, 34 U.C.C. Rep. Serv. (Callaghan) 213 (Tex. App. 1982).

guarantor since there was no indication from the signature that it was the principal, under U.C.C. section 3-603(2) even a stranger to the instrument could pay it and then enforce it as a transferee.

### *Signature of Drawee*

A drawee is not liable on an instrument until it accepts it.[90] Acceptance is the drawee's signed engagement to honor the draft as presented, and may consist of a signature alone.[91] The courts have treated so-called bank personal money orders as normal checks, and not as instruments accepted by the issuing bank.[92] However, in time for this year's survey, the Arkansas Supreme Court has determined that a bank personal money order is accepted at issuance, and therefore the issuing bank cannot stop payment.[93] All subcommittee members commenting on the case at a minimum agree that it is out of step. One member also raised what surely will be the next question—will the court reconsider if the person seeking to have payment stopped is the customer of the bank, and not the bank itself? Another interesting issue posed by the decision, since these instruments usually are not filled out when issued except as to amount, is what may the bank do if its customer asserts the instrument is forged or the indorsement of the payee is unauthorized.

The case of *Larimore v. Weyand & Son, Inc.*[94] is in interesting contrast to the *Sportsco* decision reported in last year's annual survey.[95] The court in *Sportsco* determined that, for purposes of section 547 of the Bankruptcy Code regulating preferential transfers, the "transfer" in the case of a normal check occurred on payment and not when the check was issued. *Larimore* involved a cashier's check, which the court determined was accepted on issuance. Therefore, since the check was irrevocable by the bank or the customer of the bank, the preference period was held to begin upon the delivery of the instrument and not when payment was actually made. Since the customer's funds are paid upon issuance of a cashier's check and the customer's property in the check is transferred upon its delivery, the result reached by the court appears to be correct. However, the irrevocable nature of the instrument may be overstated, as noted later in this annual survey.

90. U.C.C. § 3-409(1).

91. U.C.C. § 3-410(1).

92. *See, e.g.,* Berler v. Barclays Bank, 442 N.Y.S.2d 54, 32 U.C.C. Rep. Serv. (Callaghan) 210 (N.Y. Sup. Ct. 1981).

93. Sequoyah State Bank v. Union Nat'l Bank, 621 S.W.2d 683, 32 U.C.C. Rep. Serv. (Callaghan) 213 (Ark. 1981).

94. 33 U.C.C. Rep. Serv. (Callaghan) 627 (M.D. Fla. 1981).

95. *In re* Sportsco, 12 Bankr. 34, 31 U.C.C. Rep. Serv. (Callaghan) 1650 (D. Ariz. 1981), discussed in Miller, *Annual Survey—Commercial Paper, Bank Deposits and Collections, and Letters of Credit,* 37 Bus. Law. 973, 979 (1982).

### *Defenses: Failure of Consideration*

A case worthy of mention this year is *Deep South Services, Inc. v. Wade.*[96] U.C.C. section 3-408 states in part that want or failure of consideration is a defense as against any person not having the rights of a holder in due course, except that no consideration is necessary for an instrument or obligation on an instrument given in payment of or as security for an antecedent obligation of any kind. In the *Wade* case, a promise was made to accommodation parties to induce their signatures. The promise was not carried out and, when sued, they raised failure of consideration as a defense. The court considered it was literally applying the "except" clause of section 3-408 and allowed the defense. As one subcommittee member notes, "no consideration" should mean there is no need for *any* consideration, *ever*. On the other hand, perhaps the court's conclusion should be read as merely expressing the net result of liability on the instrument set off by liability in the same amount for breach of the promise.

### *Defenses: Forgery and Alteration*

As in past years, the opprobrious twins of forgery and alteration continue to prompt considerable litigation. With the exception of the person who pays an instrument on which the maker's or drawer's signature is unauthorized,[97] the Code basically allocates the loss (assuming the culprit is not a feasible defendant) to the person who dealt with the culprit, as that person is considered to be in the best position to prevent the loss.[98] However, if negligence or some other basis for preclusion enters the picture, the law may switch the loss to the precluded party.

The primary section in this regard is section 3-406. This provision precludes any person whose negligence substantially contributes to a forgery or alteration from asserting it against a holder in due course or a payor who paid the instrument in good faith and in accordance with the reasonable commercial standards of the payor's business. Several cases apply this provision in a manner worth comment this year. First, in *Travelers Insurance Co. v. Jefferson Nat'l Bank,*[99] the court interpreted the "reasonable commercial standards" language, and the similar language in section 3-419(3), to require more than showing that the payor (or representative) complied with *its own* commercial standards. Subcommittee members commenting on the case supported this conclusion.

The court in *J. Gordon Neely Enterprises, Inc. v. American Nat'l Bank*[100] then showed an appreciation for the realities in applying the appropriate standard to a given fact situation. In essence, the court said that even though some checks involved contained visible minor erasures or other minor irregulari-

96. 281 S.E.2d 561, 31 U.C.C. Rep. Serv. (Callaghan) 1645 (Ga. 1981).

97. The payor bears the loss in this instance as it should know the maker's or drawer's signature. Price v. Neal, 3 Burr. 1354 (1762) and U.C.C. §§ 3-418, 3-417(1)(b), 4-207(1)(b).

98. U.C.C. §§ 3-418, 3-417(1)(a), (c); (2)(a), (c), and 4-207(1)(a), (c); (2)(a), (c).

99. 404 So. 2d 1131, 32 U.C.C. Rep. Serv. (Callaghan) 1144 (Fla. App. 1981).

100. 403 So. 2d 887, 32 U.C.C. Rep. Serv. (Callaghan) 1525 (Ala. 1981)

ties, whether or not to pay them was a judgment call under all the circumstances. In short, payment of anything other than a pristine instrument cannot itself be considered a violation of reasonable commercial standards.[101] The opinion in *Aetna Casualty & Surety Co. v. Hepler State Bank*[102] evidences a less flexible approach, but perhaps represents a growing consensus. The court thought that a bank which fails to inquire concerning an individual cashing or depositing a check made payable to a business entity such as a corporation and is then indorsed, engages in an unreasonable commercial practice as a matter of law.

A possible way to deal with the problem in the *Aetna* case if the culprit is an employee or agent exceeding his or her authority is suggested by *Aimco Imports, Ltd. v. Industrial Valley Bank & Trust Co.*[103] There the court upheld a deposit agreement which expressly permitted the bank to deal with corporate checks as if they were those of an authorized signing officer and permitted the use of company checks for the personal benefit of the signer. On the other hand, in *Cumis Insurance Society, Inc. v. Girard Bank,*[104] the court indicated that a similar risk-shifting agreement would not be permitted as a matter of public policy. In the *Cumis* case, the deposit agreement allowed the bank to honor checks bearing or purporting to bear facsimile signatures, with the same effect as if the signatures were manual. The court interpreted the agreement not to protect the bank against a claim involving forged instruments, as the bank would not be protected in that instance if a manual signature had been forged. While the strict construction which the court thus gives to language which is in fairly common use is of concern, it presents only a drafting problem.[105] Much more troublesome is the suggested inability to deal with the issue by agreement. No subcommittee member commenting on the case approved this position of the court, and several believed that rather than striking an agreement that might permit negligence, the better approach would be, in the agreement or by interpretation, to allow negligence to limit the effect of the agreement.

A U.C.C. section whose relationship to section 3-406 is not entirely clear is section 3-404. Section 3-404(1) provides, in part, that any unauthorized signature is wholly inoperative as that of the person whose name is signed unless he ratifies it or is precluded from denying it. The provision covers negligence which

101. On the other hand, the court found that leaving spaces in written checks was negligence on the part of the drawer that substantially contributed to the loss. This is standard learning. U.C.C. § 3-406, comments 1–3. The court also determined that a failure to check out the employee who was entrusted with duties concerning checks, and to separate the functions of issuing checks and reconciling statements, constituted negligence substantially contributing to the alterations. No subcommittee member disagrees with the decision, although one member comments that even minor erasures should raise a serious question as to the commercial reasonableness of the bank.

102. 630 P.2d 721, 32 U.C.C. Rep. Serv. (Callaghan) 187 (Kan. App. 1981).

103. 435 A.2d 884 (Pa. Super. 1981).

104. 522 F. Supp. 414, 32 U.C.C. Rep. Serv. (Callaghan) 877 (E.D. Pa. 1981).

105. A somewhat similar case to *Cumis* is Mercantile Stores Co. v. Idaho First Nat'l Bank, 641 P.2d 1007 (Idaho App. 1982). There, under a similarly worded resolution, the bank lost when the forger used a facsimile-signed check to trace the signature onto other checks.

precludes a denial of the signature.[106] Thus an issue is framed: can a person who does not qualify to invoke preclusion based upon negligence under section 3-406 because of a lack of good faith or a failure to observe reasonable commercial standards, nonetheless do so under section 3-404? In the last year's survey, *Trust Company of Georgia Bank v. Port Terminal & Warehousing Co.*[107] was noted, which answered that question negatively. This year two cases raise a similar question: whether a person asserting ratification, which is covered under section 3-404 but not under section 3-406, must be in good faith and have acted in accordance with reasonable commercial standards. Both cases decide the answer is no.[108] To the extent they ignore U.C.C. section 1-203, which imposes an obligation of good faith in the performance or enforcement of every contract or duty within the Code, neither decision is entirely correct.

The same question has arisen with respect to section 3-405, which creates a conclusive presumption of negligence of the maker or drawer in imposter, fictitious payee, and padded-payroll-type cases.[109] The court in *Western Casualty & Surety Co. v. Citizens Bank,*[110] held that, except for an obligation of good faith, U.C.C. section 3-405 imposes an absolute loss allocation, and leaves no room for a consideration of negligence. Subcommittee members commenting agree with this position. Nonetheless, a New York court has been persuaded that the drawer stated a cause of action in negligence against the drawee even though the drawer was barred under section 3-405 from recovery against a collecting bank for dealing with checks payable to a corporation, which were then indorsed in blank (rather than for deposit) and deposited in accounts other than those of the corporate payee.[111]

To invoke the benefit of section 3-405, however, the indorsement must be in the name of the named payee.[112] What that means is becoming the subject of litigation. In *Western Casualty & Surety Co. v. Citizens Bank,*[113] the court determined that an indorsement which misspelled "Greater" as "Grater" was

106. U.C.C. § 3-404, comment 4.

107. 266 S.E.2d 254, U.C.C. Rep. Serv. (Callaghan) 1181 (Ga. App. 1980), noted in Miller, *Annual Survey—Commercial Paper, Bank Deposits and Collections, and Letters of Credit,* 37 Bus. Law. 973, 981 (1982).

108. American Travel Corp. v. Central Carolina Bank & Trust Co., 291 S.E.2d 892, 33 U.C.C. Rep. Serv. (Callaghan) 1707 (N.C. App. 1982) and Eutsler v. First Nat'l Bank, 32 U.C.C. Rep. Serv. (Callaghan) 1509 (Okla. 1982).

109. In essence, U.C.C. § 3-405 makes what otherwise would be a forged indorsement legally good where an imposter has induced issuance of the instrument payable to another, the signer of the instrument intends the payee to have no interest, or a person supplying the name of the payee has the intent the payee have no interest.

110. 676 F.2d 1344, 33 U.C.C. Rep. Serv. (Callaghan) 1018 (10th Cir. 1982).

111. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank, 440 N.Y.S.2d 643, 32 U.C.C. Rep. Serv. (Callaghan) 197 (N.Y. Sup. Ct. 1981). The New York Court of Appeals has reversed on the ground this position is not in accord with U.C.C. § 3-405. Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Chemical Bank, 34 U.C.C. Rep. Serv. (Callaghan) 1489 (N.Y. Ct. App. 1982).

112. U.C.C. § 3-405(1).

113. 676 F.2d 1344.

not fatal. On the other hand, the court in *First Nat'l Bank v. Security Nat'l Bank*[114] found that an indorsement "Longview Fibre Products," when the payee was named as "Longview Fibre Co.," rendered section 3-405 inapplicable. Subcommittee members commenting on the case thought the latter case was too strict. The standard used by the court in *Western Casualty* was whether the instrument presented a normal appearance. One subcommittee member translated this to mean: does the discrepancy appear to be only a typographical type of error? Perhaps a useful suggestion is the same standard of irregularity that would provide notice to prevent holder-in-due-course status under section 3-304(1)(a).[115]

Section 4-406 is another particularized version of a negligence preclusion similar to section 3-406 in that it generally requires the person asserting the preclusion to be in good faith and to have used ordinary care.[116] In essence, section 4-406 requires that the customer of a bank monitor activity in his or her account to alert the bank to forged or altered instruments.[117] However, to trigger the preclusion, the bank must have sent the customer a statement and the items paid, held the statement and items pursuant to instructions, or otherwise have made the statement and items reasonably available.[118] Three cases in the period covered by this year's survey discuss this requirement.

The institution in *Florida Federal Savings & Loan Ass'n v. Martin*[119] simply never returned the items with the statement or otherwise made them readily available. The court had no trouble in finding that the institution could not avail itself of the protection of section 4-406 as to forged items. The significance of the case is that it points up a problem for check truncation, where checks are not forwarded to the drawee and instead the information is forwarded electronically and only a descriptive statement is furnished to the customer. In the other two cases, the argument centered around whether the statement and items had been made available properly. In *Cooley v. First Nat'l Bank*,[120] the court correctly ruled that, where a small corporation of three persons authorized the bank to send statements to a post office box to which all three persons had access and the bank complied, there was no ground for complaint when the mailed statements included checks signed by less than the required number necessary for an authorized signature. Similarly, in *Fuller v. Flanders*[121] the executor and an

114. 32 U.C.C. Rep. Serv. (Callaghan) 926 (D. Mass. 1981).

115. U.C.C. § 3-304(1)(a) in part states that a purchaser has notice if the instrument is so irregular as to call into question its validity, terms, or ownership, or to create an ambiguity as to the party to pay.

116. U.C.C. § 4-406(1), (3).

117. U.C.C. § 4-406(4), which establishes a statute of limitations for asserting the impropriety of items paid without regard to lack of care of either party, further covers unauthorized indorsements. Section 4-406(1) also covers the unauthorized signature of the customer, as well as a forgery. *See* U.C.C. § 1-201(43).

118. U.C.C. § 4-406(1).

119. 400 So. 2d 151, 33 U.C.C. Rep. Serv. (Callaghan) 1427 (Fla. App. 1981).

120. 635 S.W.2d 250, 33 U.C.C. Rep. Serv. (Callaghan) 1736 (Ark. 1982).

121. 33 U.C.C. Rep. Serv. (Callaghan) 1447 (Mass. 1982).

attorney were both named on the account and the address of the former was given as "in care of" the latter even though the bank also was furnished the home address of the executor. However, the court reached the questionable conclusion that whether the statement sent only to the attorney, who cleaned out the account by forging the executor's signature, was reasonably available, depended on all the circumstances. Perhaps an additional factor influencing the court was the fact that the executor had not been present when the account was opened, and so the opportunity for wrongdoing should have been obvious to the bank. But, as one subcommittee member observed, the opinion is unsatisfactory in that it furnishes little guidance as to what facts will be held to preclude reliance on what the parties have designated.

A number of cases also worth mention this year raise interesting points in connection with placing the ultimate responsibility for loss with respect to instruments bearing unauthorized or missing indorsements. *Denn v. First State Bank*[122] represents an unusual retreat from judicial interpretation in that the court refused to follow *Cooper v. Union Bank*[123] and permit the payee to sue the depositary and collecting banks directly for handling an instrument bearing his forged indorsement. The court followed what it perceived to be the Code rule that a depositary or collecting bank which in good faith and in accordance with the reasonable commercial standards applicable to its business dealt with an instrument or its proceeds in a manner generating liability is not liable beyond the amount of any proceeds still in its hands.[124] The court then stated that any other rule should be by further legislation.

In *Commonwealth Federal Sav. & Loan Ass'n v. First Nat'l Bank*[125] the court never reached the issue addressed in *Denn*. The court first held that checks paid on forged or missing indorsements were converted, either under U.C.C. section 3-419(1)(c) which provides that an instrument is converted when it is paid on a forged indorsement, or under the common law of conversion as applicable through U.C.C. section 1-103.[126] U.C.C. section 3-419(3) was not discussed. Rather negligence precluding the assertion of the missing or forged indorsements under section 3-406 was argued. The court's conclusion was no different than if section 3-419(3) had been considered, as the court did not find the bank had acted in good faith and in accordance with reasonable commercial

122. 316 N.W.2d 532, 33 U.C.C. Rep. Serv. (Callaghan) 321 (Minn. 1982).

123. 507 P.2d 609, 11 U.C.C. Rep. Serv. (Callaghan) 343; 12 U.C.C. Rep. Serv. (Callaghan) 209 (Calif. 1973), noted in Miller, *Annual Survey—Commercial Paper, Bank Deposits and Collections, and Letters of Credit,* 37 Bus. Law. 973, 983 (1982).

124. U.C.C. § 3-419(3).

125. 513 F. Supp. 296, 34 U.C.C. Rep. Serv. (Callaghan) 218 (E.D. Pa. 1979).

126. Another case also holding that a missing indorsement may lead to conversion liability is Humberto Decorators, Inc. v. Plaza Nat'l Bank, 434 A.2d 618, 32 U.C.C. Rep. Serv. (Callaghan) 494 (N.J. Super. Ct. 1981). On the other hand, one subcommittee member believes the result in Drug House, Inc. v. Keystone Bank, 414 A.2d 704, 31 U.C.C. Rep. Serv. (Callaghan) 1638 (Pa. Super. Ct. 1979), to be discussed *infra* at text accompanying note 131 for another proposition, may be explained by the view that no conversion exists where an indorsement is missing.

standards. The court considered the principal failure[127] in this regard was allowing the deposit of checks payable to an organization in other than the account of the organization. The court found this violated both the procedures of the depositary institution itself and general commercial standards.[128]

Three cases appear to point out that in order to have a cause of action for conversion, the check must have been issued to the payee. Under U.C.C. section 3-102(1)(a), "issue" is defined as the first delivery of an instrument to a holder or a remitter. In *Humberto Decorators, Inc. v. Plaza Nat'l Bank,*[129] a cashier's check payable to the plaintiff was delivered to *X,* a debtor of the plaintiff, who deposited it without indorsement in his own account at the bank which had issued the check. The court allowed the plaintiff to sue the bank in conversion on the ground that delivery of the check to *X* was delivery of it to the plaintiff because *X* was plaintiff's agent for this purpose on the facts involved.[130] On the other hand, in *Drug House, Inc. v. Keystone Bank,*[131] a payee was denied suit against the drawee for payment of a check which the payee never received or negotiated and which apparently was misdirected to a third party who deposited it for collection. And in *DiMonda v. Freedom Federal Savings,*[132] a person withdrew $2500 from his savings account and procured a check in that amount drawn by the institution on its own bank and payable to *X*. The person (remitter) then took the check to a travel agent to mail to *X*. Instead, the travel agent forged *X*'s indorsement. Presumably because *X* never obtained the check, the remitter sued both the drawer and the drawee. Both actions were denied. As one subcommittee member expressed it, the decision leaves you with a feeling of emptiness. We do not know why the drawer, for its customer the remitter, did not use section 4-401 to force a recredit by its bank, the drawee, which would then have had to pursue its transferor.[133] We can guess, however. In any event, a

127. Another failure worth mentioning is that the forged indorsement of the payee organization was deficient in that it never used the payee's name. What appeared only to be an individual's signature was all that was used.

128. *See supra* text after note 102.

129. 434 A.2d 618, 32 U.C.C. Rep. Serv. (Callaghan) 494 (N.J. Super. Ct. 1981).

130. Note that even though there was no forged indorsement, the bank converted the plaintiff's property in a way no different than if plaintiff's indorsement had been forged. In Grosberg v. Michigan Nat'l Bank, 318 N.W.2d 490, 33 U.C.C. Rep. Serv. (Callaghan) 1443 (Mich. App. 1982), *X* opened an account for himself and *Y* by forging *Y*'s name. Checks payable to *X* or to *Y* or to both for rents on property they owned were deposited with *X*'s indorsement. The bank supplied *Y*'s necessary indorsements pursuant to U.C.C. § 4-205(1). The court denied any cause of action by *Y* against the bank. Although one subcommittee member believes the decision is correct, this writer thinks the court overlooked the fact the bank converted *Y*'s interest in the checks, even though no indorsement was forged, because the original forgery in opening the account gave the bank no right to deal with *Y*'s property.

131. 414 A.2d 704, 31 U.C.C. Rep. Serv. (Callaghan) 1638 (Pa. Super. Ct. 1979). *See also supra* note 126.

132. 32 U.C.C. Rep. Serv. (Callaghan) 492 (Boston Mun. Ct. 1981), *aff'd,* 434 N.E.2d 210, 33 U.C.C. Rep. Serv. (Callaghan) 1025 (Mass. 1982).

133. U.C.C. § 4-207(1)(a). In Home Indemnity Co. v. First Nat'l Bank, 659 F.2d 796, 31 U.C.C. Rep. Serv. (Callaghan) 1664 (7th Cir. 1981), the court held that the duty of the payor to notify its transferor under § 4-207(4) of an asserted breach of the warranty of title due to a forged

more original suggestion is that until the payee receives the check, the remitter should be held to have the property interest in it for purposes of a conversion suit.

Finally, a rather interesting case for this survey involves a forged instrument. In *Schleicher v. Western State Bank,*[134] the plaintiff assertedly without knowing took a forged check, and presented it for payment to the drawee. The drawee paid it. Any debit by the drawee of the account of the purported drawer would be a breach of duty to its customer, and, moreover, payment is final.[135] One gets the sense, however, that to induce the plaintiff to work things out, the plaintiff was arrested for passing a forged check. The suit against the drawee bank for malicious prosecution, defamation, invasion of privacy, negligence, and various other causes of action followed. The court granted summary judgment for the bank, however, on the basis that no instigation of the arrest by the bank was shown and, as to negligence, the bank had no duty to the plaintiff payee to make sure the instrument was genuine when the plaintiff was not a customer.

### *Defenses: Discharge*

As seems to be the recurring pattern, most cases center on the so-called surety defenses[136] in U.C.C. section 3-606 of impairment of recourse or of collateral. Two cases represent strict readings by the courts. In *North Bank v. Circle Investment Co.,*[137] an agreement by the holder of the instrument to extend the time for payment was made without the consent of the surety or any reservation of rights.[138] The court held even though the agreement was not enforceable due to lack of consideration, the mere making of it discharged the surety. Section 3-606(1)(a) does use the word "agrees," and under section 1-201(3) the agreement is the bargain of the parties in fact, as opposed to their contract, which is defined in section 1-201 as the legal obligation which results from the agreement. In *Van Balen v. Peoples Bank & Trust Co.,*[139] the guarantors established an unjustifiable impairment of collateral, but did not obtain a

indorsement is not postponed until an affidavit from the payee is received but instead arises as soon as the payor knows the check has been paid even though not negotiated by the payee. *See also* First Nat'l Bank v. Trust Co. of Cobb Co., 510 F. Supp. 651, 32 U.C.C. Rep. Serv. (Callaghan) 909 (N.D. Ga. 1981), where the court found a delay of 77 days in giving notice to be unreasonable, but moot where no loss because of it was proved since some funds were withdrawn before notice reasonably was due and the balance had been retained to cover overdrafts. One subcommittee member questions whether loss might have been demonstrated with better proof.

134. 314 N.W.2d 293, 33 U.C.C. Rep. Serv. (Callaghan) 1035 (N.D. 1982).

135. U.C.C. § 3-418, comment 1.

136. *See* U.C.C. § 3-606, comment 1, and Fall River Sav. Bank v. Lebel, 20 Bankr. 98, 33 U.C.C. Rep. Serv. (Callaghan) 1041 (Mass. App. 1982) (where *A* and *B* jointly and severally executed a note, absent evidence that *A* was a surety for *B* and that the bank knew of a right of recourse by *A* against *B,* the release of *B* upon the payment of $500 does not discharge *A*).

137. 434 N.E.2d 1004, 33 U.C.C. Rep. Serv. (Callaghan) 1430 (Ill. App. 1982).

138. Either consent or reservation would have preserved rights against the surety. U.C.C. § 3-606(1)(a).

139. 626 S.W.2d 205, 33 U.C.C. Rep. Serv. (Callaghan) 1046 (Ark. App. 1982).

discharge when they failed to establish the *extent* of the impairment, which also is necessary under section 3-606(1)(b). Subcommittee members thought both cases should have been tempered with a little more flexibility; for example, a remand in the *Van Balen* case.

On the other hand, a court showed flexibility when it overturned an earlier decision that drew a distinction between a release of collateral and a failure to perfect a security interest in collateral. The case involved a clause in an instrument whereby the surety consented to the release of collateral. The earlier decision releasing the surety when the security interest was not perfected was changed in *Executive Bank v. Tighe,*[140] and the greater was held to include the lesser. Such a generous reading may come in handy for a fact situation like that in *Chemical Bank v. Valentine.*[141] There it was argued that an accommodation maker was discharged by the failure of the secured-party holder of the instrument to object to being listed in the principal's bankruptcy as an unsecured creditor. As one subcommittee member notes, the facts are not clear, but perhaps the court rejected the argument because the action of the secured party did not constitute a "final release," in that the listing by the debtor did not require an objection if a secured claim would subsequently be timely filed.

A final case under section 3-606 appears to be correctly decided even though one's first reaction may be to the contrary. In *Ottenheimer Publishers, Inc. v. Regal Publishers, Inc.,*[142] the debtor owed a debt to a bank, which was a secured party. The notes were guaranteed by parties interested in the debtor. The debtor then granted a security interest in the same collateral to the plaintiff, to secure a debt. On the debtor's default, the plaintiff, by agreement with the bank, liquidated the collateral, paid the bank, and took an assignment of the notes held by the bank and of bank's security interest. In a suit against the guarantors, the court held they had been discharged. The aspect of the opinion that gives one pause is that the result would be different if the plaintiff had used its own funds to pay the bank. However, in that case, the guarantors would still have had recourse to the collateral.

Two cases decided during the period for this survey also interpret section 3-605. This section provides in part that a holder may discharge any party by intentionally cancelling the instrument.[143] *Gibraltar Savings Ass'n v. Watson*[144] illustrates the operation of this provision. In that case, a note was marked as paid due to a mistake in crediting the makers with more than they had paid. The court found no discharge because the cancellation had not been intentional. In contrast, in *Peterson v. Crown Financial Corp.,*[145] the holder asserted that

140. 429 N.E.2d 1054, 32 U.C.C. Rep. Serv. (Callaghan) 894 (N.Y. 1981). At least one subcommittee member expressed agreement with the earlier decision. At bottom, the safe course is to specify both situations in the consent clause in the instrument.

141. 32 U.C.C. Rep. Serv. (Callaghan) 901 (N.Y. Sup. Ct. 1981).

142. 626 S.W.2d 276, 33 U.C.C. Rep. Serv. (Callaghan) 330 (Tenn. App. 1981).

143. U.C.C. § 3-605(1)(a).

144. 624 S.W.2d 650, 32 U.C.C. Rep. Serv. (Callaghan) 1520 (Tex. App. 1981).

145. 661 F.2d 287, 32 U.C.C. Rep. Serv. (Callaghan) 497 (3rd Cir. 1981).

there had been no subjective intent to alter the terms of an old note when it was intentionally cancelled and returned in exchange for a new note, which the court interpreted to represent a lesser indebtedness. The court refused to admit the evidence of intent on the ground it would impair the certainty of writings. Clearly, allowing parol evidence to contradict a new writing is quite different from allowing it to show that an old writing was not intentionally extinguished.

*Defenses: Statute of Limitations*

The opinion in *Ligran, Inc. v. Medlawtel, Inc.,*[146] that a guarantor of payment is liable as a maker and a cause of action accrues against the guarantor on the date of issue of a demand note, was affirmed.[147]

*Defenses: Partial Payment in Full Settlement and Payment*

The dispute over whether U.C.C. section 1-207 changes the common law of accord and satisfaction continues in cases considered for this year's survey. Not only is there a difference of opinion among jurisdictions, we now are seeing disputes *within* jurisdictions. In New York, the courts in *Gimby v. Frost*[148] and in *William Manfredi Construction Corp. v. Green Fan Co.,*[149] both concluded that indorsing "without prejudice and reserving all rights" or "payment in protest" do not prevent an accord and satisfaction. *Braun v. C.E.P.C. Distributors*[150] earlier had held that following section 1-207 prevented an accord and satisfaction. And in *Aguiar v. Harper & Row Publishers, Inc.*[151] yet another New York court joined the fray, deciding that section 1-207 will work so long as the underlying transaction is within the Code. In Florida, the split is represented by *Eder v. Yvette B. Gervey Interiors, Inc.,*[152] which denies following section 1-207 prevents an accord and satisfaction, and by *Miller v. Jung,*[153] which goes the other way.

California has joined the overall debate in *Connecticut Printers, Inc. v. Gus Kroesen, Inc.,*[154] holding that section 1-207 does not allow a person to accept a check tendered in full payment of a disputed debt and reserve the balance of his

146. Discussed in Miller, *Annual Survey—Commercial Paper, Bank Deposits and Collections, and Letters of Credit,* 37 Bus. Law. 973, 985 (1982).

147. 432 A.2d 502, 32 U.C.C. Rep. Serv. (Callaghan) 166 (N.J. 1981).

148. 444 N.Y.S.2d 143, 33 U.C.C. Rep. Serv. (Callaghan) 805 (N.Y. Sup. Ct. 1981).

149. 448 N.Y.S.2d 43, 33 U.C.C. Rep. Serv. (Callaghan) 806 (N.Y. Sup. Ct. 1982).

150. 433 N.Y.S.2d 447, 30 U.C.C. Rep. Serv. (Callaghan) 8 (1980).

151. 452 N.Y.S.2d 519, 34 U.C.C. Rep. Serv. (Callaghan) 6 (N.Y. Civ. Ct. 1982).

152. 407 So. 2d 312, 33 U.C.C. Rep. Serv. (Callaghan) 146 (Fla. App. 1981).

153. 361 So. 2d 788, 24 U.C.C. Rep. Serv. (Callaghan) 1085 (Fla. App. 1978). A subcommittee member advises that the dispute in Florida has been certified to the Florida Supreme Court for resolution.

154. 34 U.C.C. Rep. Serv. (Callaghan) 1 (Cal. App. 1982).

rights. Most subcommittee members see this result both as the trend and as the correct result.[155]

Two other cases in this area are worth note. In *Kelly v. Kowalsky*,[156] the creditor merely kept the check tendered in full payment. The court permitted this without an accord and satisfaction, if the creditor explained the ground for retention.[157] *Savings & Loan Ass'n v. Tear*[158] involved a somewhat different point. The debtor on a mortgage apparently was late in making payments. A money order for a late payment was tendered, accepted, and indorsed. Then the mortgagee, either reconsidering the long-run problem of constant late payments or, more likely, when the status of the mortgage was reviewed by an officer of the mortgagee as opposed to a clerk, decided to return the money order and begin foreclosure. It was told that under U.C.C. section 3-802(1)(b) its acceptance of the instrument had suspended the mortgage obligation until presentment of the money order, which had not occurred. No foreclosure was allowed. Presumably, prompt payment or foreclosure followed the next month.

### *Holder In Due Course Status*

Holder in due course cases often are not worth reporting because the general standard for that status of being in good faith and without notice,[159] even as elaborated upon in section 3-304, makes each case turn for the most part on its own particular facts.[160] The majority and dissenting opinions in *Wohlrabe v. Pownell*[161] well illustrate this, but the case is worth mention due to the suggestic n in the majority opinion that because of its character and the reliance upon it, nore should be required in the way of notice to defeat the holder of a cashier's check than the holder of a regular check. The suggestion appeared questionable to the subcommittee members commenting on the opinion.

Subcommittee members thought even less of the court's opinion in *Seinfeld v. Commercial Bank & Trust Co.*[162] There a depositor who had been consistently overdrawn deposited $160,000 in three checks, requested immediate clearance, and was allowed to withdraw the uncollected funds. The bank did not even

155. One subcommittee member points out that in some jurisdictions the result may be controlled by a statute outside of the Code.

156. 33 U.C.C. Rep. Serv. (Callaghan) 801 (Conn. 1982).

157. One would think that this requirement would remove whatever efficacy the procedure may have had to the creditor. One subcommittee member also believes an accord and satisfaction should occur after a reasonable time.

158. 435 A.2d 1083, 32 U.C.C. Rep. Serv. (Callaghan) 1152 (Me. 1981).

159. U.C.C. § 3-302(1). The giving of "value" also is required.

160. In addition, the burden of proof is upon the person asserting holder in due course status and in close cases may well determine the outcome. U.C.C. § 3-307(3). For example, in Scarsdale Nat'l Bank & Trust Co. v. Toronto-Dominion Bank, 533 F. Supp. 378, 33 U.C.C. Rep. Serv. (Callaghan) 996 (S.D.N.Y. 1982), the court held that a holder did not meet the burden under facts which forced the holder to adopt one of two assumptions, one of which was fraud and the other of which was highly unlikely, and the holder never checked to see what the actual facts were.

161. 307 N.W.2d 478, 31 U.C.C. Rep. Serv. (Callaghan) 1401 (Minn. 1981).

162. 405 So. 2d 1039, 32 U.C.C. Rep. Serv. (Callaghan) 437 (Fla. App. 1981).

check with the drawer's bank. Of course, payment was stopped on the ground there was a defense, and the bank then asserted holder in due course status on the basis of an affidavit of a bank officer who did not actually participate in the transaction. It is hard to imagine a worse set of facts for the bank, unless it had checked and had received notice. The court denied holder in due course status, suggesting the bank had sought that status to shift some of the insolvency risk for its customer's overdrafts from itself to the drawer of the checks. Some subcommittee members believe the case reaches the right result, but most question whether it can be confined to its facts and not cast doubt on the position of other cases long considered to be sound.[163]

*A.C. Davenport & Son Co. v. United States,*[164] discussed earlier on a choice of law question, is a more satisfying case on holder in due course. There Davenport agreed to supply goods to *A,* who had a contract to resell the goods to the General Services Administration. By agreement, all payment checks were to be sent to *A* in care of Davenport and were to be deposited in an account over which Davenport had control. Nonetheless, the United States sent checks directly to *A.* Davenport discovered this, protested, and the United States stopped payment on the earlier checks and then sent a duplicate check to Davenport, which Davenport cashed. When the first checks in fact were paid, the United States sought recovery on the duplicate check. The court denied recovery against Davenport, which it characterized as the only one in the group who had acted correctly, on the ground Davenport had given value and had no adverse notice since it could assume the stop order placed on the first checks would be effective. It thus was a holder in due course.

The final issue was whether, even though a holder in due course, Davenport had dealt with the holder of the defense. Under section 3-305(2), even a holder in due course takes subject to defenses of a party with whom it has dealt. The court determined Davenport had not dealt with the drawer United States government because it did not take as a result of an "immediate transaction" with the drawer. Another interesting case along this line is *Arcanum Nat'l Bank v. Hessler.*[165] The "close-connectedness" doctrine of *Unico v. Owen*[166] is a known consumer protection rule. Under that rule, the transferee of consumer paper is charged with knowledge to prevent holder in due course status when it has a close connection with the transferor, as evidenced by the transferee supplying forms to the transferor, specifying credit terms, purchasing most of the paper generated, and perhaps common officers. In *Hessler,* the Ohio court appeared to extend this consumer protection doctrine to a commercial/agricultural transaction, although there is language in the opinion from which one

163. *See, e.g.,* Bowling Green, Inc. v. State St. Bank, 425 F.2d 81, 6 U.C.C. Rep. Serv. (Callaghan) 1151, 7 U.C.C. Rep. Serv. (Callaghan) 635 (1st Cir. 1970) and Citizens Nat'l Bank v. Fort Lee Sav. & Loan Ass'n, 213 A.2d 315, 2 U.C.C. Rep. Serv. (Callaghan) 1029 (N.J. Super. 1965).

164. 34 U.C.C. Rep. Serv. (Callaghan) 198 (N.D. Ill. 1982).

165. 433 N.E.2d 204, 33 U.C.C. Rep. Serv. (Callaghan) 604 (Ohio 1982).

166. 232 A.2d 405, 4 U.C.C. Rep. Serv. (Callaghan) 542 (N.J. 1967).

could conclude the court believed the common officers of the payee and of the transferee had reason to know of the defense, and thus the transferee had notice under a more traditional approach.

## *STOPPING PAYMENT, SET-OFF, AND THE LIKE*

Two cases involving other than stop payment orders are of possible interest this year. In *In re All-Brite Sign Service Co., Inc.,*[167] a depositary bank took checks for collection and gave provisional credit. Prior to their collection, the customer went bankrupt. The bank, when the funds were collected, argued it could set off the resulting debt it owed to its customer against a prebankruptcy debt the customer owed to it. The court found that prior to bankruptcy the bank was an agent[168] and not a debtor, and denied the set-off. The other case[169] involved a taxpayer who obtained cashier's checks payable to the state for taxes owed. Apparently, a better use for the money suggested itself, because the taxpayer returned the checks and obtained a refund. However, before that happened, the state levied upon the taxpayer's assets at the bank. The bank argued the levy was too late in that the checks were accepted upon issuance, and any process after that point came too late under U.C.C. section 4-303. The court decided the acceptance, if it existed, was for the benefit of the payee state, and never became binding by delivery or notice,[170] so the levy was effective.

Stop payment orders continue to generate the greatest number of cases. If the stop order is overlooked, the basic remedy of the payor institution appears to be subrogation under U.C.C. section 4-407 to the rights of the drawer and the payee or any other holder. However, in *Bryan v. Citizens Nat'l Bank,*[171] the court held that a bank paying over a valid stop payment order may, in addition to using section 4-407, sue to recover in restitution. To do so, it would have to show the drawer is not liable to the payee, but the person paid may then show holder-in-due-course rights to invoke finality of payment under U.C.C. section 3-418. That section makes payment or acceptance final in favor of a holder in due course or a person who in good faith has changed position in reliance on the payment. The teaching of the case seems to be that in situations where the Code does not make payment final, the subrogation remedy is optional and not exclusive.

It may be optional in practical effect even when payment is final. This depends on the construction given to U.C.C. section 4-403(3), which states that the burden of establishing the fact and amount of loss resulting from the payment of an item contrary to a binding stop payment order is on the customer. In *Delano v. Putnam Trust Co.,*[172] the court concluded that a customer could not

167. 32 U.C.C. Rep. Serv. (Callaghan) 919 (W.D. Ky. 1981).

168. *See* U.C.C. § 4-201(1).

169. State Dept. of Treasury v. Bank of the Commonwealth, 314 N.W.2d 688, 33 U.C.C. Rep. Serv. (Callaghan) 314 (Mich. App. 1981).

170. U.C.C. § 3-410(1).

171. 628 S.W.2d 761, 33 U.C.C. Rep. Serv. (Callaghan) 337 (Tex. 1982).

172. 33 U.C.C. Rep. Serv. (Callaghan) 635 (Conn. Super. Ct. 1981).

force the bank to recredit his account unless loss was shown. It was not decided whether the customer must allege and prove loss, or whether the bank must go forward with evidence to raise the issue and only then need the customer establish loss. Either way, under this view, a payor bank has no need for subrogation unless its customer prevails, which then in essence tends to make its case in subrogation.

Who has the burden of raising the issue of loss was addressed in *Siegel v. New England Merchants Nat'l Bank,*[173] although the problem there arose from early payment of a postdated check,[174] and the court applied section 4-403(3) only by analogy. The suit was to force a recredit, and the bank in defense asserted subrogation to the rights of the payee. The court held U.C.C. section 4-401 only allows a debit for a properly payable item, so the bank must recredit.[175] However, if the bank identifies whose rights it claims under section 4-407 and proves that the third party is a holder or perhaps a holder in due course, the court held that the customer must then prove his loss under section 4-403(3) by establishing a valid defense. This analysis does not seem entirely consistent if the court really means the bank must prove (or attempt to prove) holder in due course status, but perhaps that requirement should be limited to a situation not involving the payee. In any event, the opinion seems less favorable to the customer than the opinion in *Migden v. Chase Manhattan Bank, N.A.,*[176] where the bank also was given the burden of going forward with proof of no loss. It appears likely that the difference of opinion on these points among the courts will continue.[177]

This observation of continuing litigation appears equally applicable to issues concerning the validity of the stop order. The Attorney General of Michigan now opines that a fee may be charged for a stop payment order, if the agreement with the customer clearly and specifically provides.[178] It is perhaps sound advice

173. 437 N.E.2d 218, 33 U.C.C. Rep. Serv. (Callaghan) 1601 (Mass. 1982).

174. The court held such payment is not proper under U.C.C. § 4-401. In *In re* Paralelo, 18 Bankr. 433, 33 U.C.C. Rep. Serv. (Callaghan) 600 (S.D. Fla. 1982), the argument was that a postdated check was a note, and thus was not properly payable from the customer's account. The argument was rejected.

175. In American Heritage Bank & Trust Co. v. Isaac, 636 P.2d 1296, 32 U.C.C. Rep. Serv. (Callaghan) 1156 (Colo. App. 1981), the majority seems to overlook this point. One partner of a partnership wrote drafts, ostensibly for cattle purchases, on the partnership account, which were debited by the bank contrary to the deposit agreement. The court held the bank was negligent, but denied the partnership recovery because the other partner could not prove loss. He could not show the funds did not go to buy the cattle, even though 180 cattle supposedly purchased were missing. The dissent states that under U.C.C. § 4-401 the customer should be able to force a recredit and leave the bank to recover from the person improperly paid or otherwise.

176. 32 U.C.C. Rep. Serv. (Callaghan) 937 (N.Y. Civ. Ct. 1981).

177. See the discussion in last year's annual survey, Miller, *Annual Survey—Commercial Paper, Bank Deposits and Collections, and Letters of Credit,* 37 Bus. Law. 973, 989 (1982).

178. Michigan Att'y Gen. Op. No. 5947, 33 U.C.C. Rep. Serv. (Callaghan) 1445 (1981). Presumably, it must be a reasonable fee. A related issue is whether a bank may by agreement collect a service charge when the bank pays an overdraft. The court in Hoffman v. Security Pac. Nat'l Bank, 121 Cal. App. 3d 964 (1981) allowed the charge. Of course, if the bank is obligated to pay

that the agreement also specify the information for a stop order, and that the bank adhere to its requirements as well as reiterate them when a stop order is placed. That seems to be the difference between the opinions in *Delano v. Putnam Trust Co.,*[179] and *Poullier v. Nacua Motors, Inc.*[180] In *Delano,* the stop order correctly described the check in four ways but was $100 in error, and the court determined the stop order was nonetheless effective as the customer had not been advised the computer needed the exact amount. In *Poullier,* the bank advised the customer an exact figure was necessary, and an error of $40 was held to render the stop ineffective. Nonetheless, some authority seems to suggest that complete accuracy may not be insisted upon, and that the program of the bank must be designed so as to permit relatively minor variations from the amount of the instrument.[181]

The final issue which continues to cause significant litigation in this area is whether payment on a cashier's check may be stopped by the institution on its own motion or at the request of its customer. The quite simple answer is, of course payment may be refused. However, the drawer, when sued, cannot raise any personal defense it has against a holder in due course or any claim of its customer except in accordance with sections 3-306(d) and 3-603(1). Those sections permit raising the claim of a third person if theft is involved, payment would be contrary to a restrictive indorsement, or the third party defends the action. The court in *Kamp v. First Nat'l Bank*[182] followed this simple analysis where a debtor had obtained a cashier's check payable to a creditor and delivered the check to the creditor, but the issuing bank was unable to retain its consideration for the check due to the bankruptcy of the debtor. The court held that the bank could not defeat recovery by the creditor, who was a holder in due

overdrafts by agreement, credit is involved, and the charge may be subject to usury limitations. *See, e.g.,* Uniform Consumer Credit Code § 1.301(16), (20) (1974).

179. 33 U.C.C. Rep. Serv. (Callaghan) 635 (Conn. Super. Ct. 1981).

180. 439 N.Y.S.2d 85, 32 U.C.C. Rep. Serv. (Callaghan) 258 (N.Y. Sup. Ct. 1981).

181. Migden v. Chase Manhattan Bank, N.A., 32 U.C.C. Rep. Serv. (Callaghan) 937 (N.Y. Civ. Ct. 1981) (error of $5 amounting to less than one percent of check amount does not render stop order invalid as computer should be programed differently); and FJS Electronics, Inc. v. Fidelity Bank, 431 A.2d 326, 31 U.C.C. Rep. Serv. (Callaghan) 1669 (Pa. Super. Ct. 1981) (stop order 50¢ off, even though customer advised exact amount needed and computer programed for exact amount, was binding as afforded reasonable opportunity to bank to act and inevitable occasional losses should be borne by bank).

A somewhat related type of case is Thomas V. Bank of Springfield, 631 S.W.2d 346 (Mo. App. 1982). The agreement with the bank did not permit an oral stop order. Nonetheless, one was accepted and acted upon by the bank. In the suit when the bank paid over the oral stop order, the court had little trouble in deciding that the bank had waived its requirement, but did not decide whether the requirement was valid; that is, whether oral stop orders may be eliminated by contract.

182. 32 U.C.C. Rep. Serv. (Callaghan) 902 (D. Minn. 1981).

course,[183] with its defense of fraud by the debtor in not disclosing that his bankruptcy was imminent.[184]

On the other hand, the court in *Abilities, Inc. v. Citibank, N.A.*[185] followed the more convoluted approach adopted by some courts, and held that a cashier's check cannot be stopped because it is accepted upon issuance, and thus the cut-off point for stopping payment is past.[186] The same result in the *Abilities* case would be reached under the other approach. The bank had stopped payment at the request of its customer, who had a defense of failure of consideration. As this is not a claim to property but rather a defense to payment, sections 3-306(d) and 3-603(1) do not allow the third-party customer to assert the defense. An approach similar to that used by the court in *Abilities, Inc.* was also adopted in *Neve-Welch Enterprises, Inc. v. United Bank,*[187] where the court refused to allow the bank to deny payment on the basis the remitter of the cashier's check had failed to cover the check with deposits. The court reasoned that this result was necessary to maintain the essential reliability of cashier's checks. Without disagreeing with the court's conclusion as to result, the short answer should have been that the bank's defense of no consideration was not good against the holder who was a holder in due course.[188]

Even the courts that follow the point of view of the *Abilities, Inc.* case do not do so without exception. An example is *Kaiser-Georgetown Community Health Plan, Inc. v. Bankers Co. of Albany, N.A.,*[189] where a bank was held liable to the owner of a certificate of deposit when the bank received a cashier's check payable to it representing the proceeds of the certificate and allowed the check to be deposited to the personal account of a third party without raising any question. The defense of the bank was that no question would have mattered since payment on the cashier's check could not have been stopped. The court replied that under certain circumstances payment of a cashier's check can be stopped. Therein lies the problem with this point of view: what are those circumstances? At least these courts do express a definite point of view. Which view is applicable in Massachusetts apparently must await another case. In *Louis Falcigno Enterprises, Inc. v. Massachusetts Bank & Trust Co.,*[190] the court refused to approve either theory and resolved the case on the ground that the customer's objection constituted only a defense so that it was not assertable under either point of view.

183. U.C.C. § 3-802(1)(a) in this situation provides that the underlying obligation is discharged. That constitutes "value" under § 3-303(b) to allow holder in due course status. U.C.C. § 3-302(1).

184. This would be fraud in the inducement and not the real defense of fraud in the factum that is good against a holder in due course. U.C.C. § 3-305(2)(c).

185. 449 N.Y.S.2d 242, 33 U.C.C. Rep. Serv. (Callaghan) 1428 (N.Y. Sup. Ct. 1982).

186. *See* U.C.C. § 4-303(1)(a)—a stop order comes too late when the bank has accepted or certified the item.

187. 628 P.2d 1297, 32 U.C.C. Rep. Serv. (Callaghan) 173 (Utah 1981).

188. U.C.C. §§ 3-305(2), 3-306(c).

189. 442 N.Y.S.2d 48, 32 U.C.C. Rep. Serv. (Callaghan) 229 (N.Y. Sup. Ct. 1982).

190. 426 N.E.2d 993, 34 U.C.C. Rep. Serv. (Callaghan) 206 (Mass. App. 1982).

## *WRONGFUL DISHONOR*

While this topic primarily concerns the liability of a payor bank under U.C.C. section 4-402 for failure to honor an item properly payable in accordance with U.C.C. section 4-401, two other cases involving asserted improper dishonor might be mentioned. Both cases concern the rule that an unexcused delay of notice of dishonor may discharge a secondary[191] party.[192] In *Lufthansa German Airlines v. Bank of America,*[193] the court stated that the time for a collecting bank to notify a customer of dishonor does not begin to run until the bank has learned sufficient facts to enable it to give appropriate notice, including identification of the customer.[194] In *First Nat'l Bank v. Linn,*[195] notice of dishonor was not properly given to the corporate seller of goods, who had indorsed the note of the buyers of the goods including a guarantee of payment. Notice of dishonor also was not properly given to two officers of the seller who had personally indorsed the note. The court found the latter were discharged, but not the former.[196]

Turning to wrongful dishonor by a payor bank, several interesting cases were decided during the period of this year's survey. Section 4-402 makes the bank liable to its customer for a wrongful dishonor. It is not clear whether this excludes recovery, for example, by a partner where his or her business reputation is damaged by the dishonor of a partnership check, the partnership being the customer.[197] The court in *Shreveport Production Credit Ass'n v. Bank of Commerce,*[198] however, decided that the payee of the dishonored item had no cause of action; it held the payee had no standing to assert a wrongful dishonor even if one were present in the case.

What constitutes a wrongful dishonor was considered in two cases. In *Raymer v. Bay State Nat'l Bank,*[199] in dicta the court suggested that an inappropriate reason given for a proper dishonor did not constitute a wrongful dishonor.[200] In *C-K Enterprises v. Depositors Trust Co.,*[201] the court concluded

191. A drawer or an indorser. U.C.C. § 3-102(1)(d).

192. U.C.C. § 3-502 is the section that provides for discharge.

193. 652 F.2d 835, 31 U.C.C. Rep. Serv. (Callaghan) 1426 (9th Cir. 1981).

194. Once the time begins to run, the bank generally must give notice before its midnight deadline, which under § 4-104(1)(h) is midnight on its next banking day after the banking day of receipt. U.C.C. §§ 3-508(2), 4-212(1).

195. 282 S.E.2d 52, 32 U.C.C. Rep. Serv. (Callaghan) 218 (W. Va. 1981).

196. The reason is the guarantor of payment waived notice of dishonor under U.C.C. § 3-416(1), (5) but not the accommodation indorsers. U.C.C. §§ 3-415(2), 3-501(2)(a), 3-502(1)(a).

197. *Compare* Loucks v. Albuquerque Nat'l Bank, 418 P.2d 191, 3 U.C.C. Rep. Serv. (Callaghan) 709 (N.M. 1966) (no cause of action) *with* Macrum v. Security Trust & Sav. Co., 129 So. 74 (Ala. 1930) (cause of action, at least pre-Code); *but see* § 1-103.

198. 405 So. 2d 842, 32 U.C.C. Rep. Serv. (Callaghan) 1551 (La. 1981).

199. 424 N.E.2d 515, 31 U.C.C. Rep. Serv. (Callaghan) 1537 (Mass. 1981).

200. The reason given was "uncollected funds" when the actual reason was insufficient funds due to a dishonored instrument. The court thus diverges from the other point of view expressed in Johnson v. Grant Square Bank & Trust Co., 634 P.2d 1324, 31 U.C.C. Rep. Serv. (Callaghan) 1062 (Okla. App. 1981), reported on last year in Miller, *Annual Survey—Commercial Paper,*

that too hasty action in otherwise properly closing a customer's account might subject the bank to liability for wrongful dishonor of any checks thereby left unpaid and, to prevent such liability, reasonable notice should be given.

What can be recovered in the case of a wrongful dishonor is the subject of several cases. The court in *Shaw v. Union Bank & Trust Co.*[202] indicated that it would allow consequential damages for mental distress under appropriate circumstances (where proximately caused)[203] and, where the conduct was malicious, punitive damages.[204] In *Morse v. Mutual Federal Sav. & Loan Ass'n*,[205] the plaintiff owed the defendant on a note that became due. The defendant then refused to pay drafts drawn on the plaintiff's NOW account on the basis the account had been set off to liquidate the note. However, the defendant continued to charge interest on the note debt as if it was still unpaid. The court held that these facts involved a wrongful dishonor and, since it was not by mistake, it was not relevant whether mental suffering and loss of reputation were actual damages, or were recoverable merely on evidence that the bounced drafts caused some indirect decline in business and that the drawer suffered mentally.[206] On the other hand, in *Yacht Club Sales & Service, Inc. v. First Nat'l Bank*,[207] the court, on rehearing its earlier decision,[208] determined that the Code entirely does away with the trader rule, which allows a person in business to recover substantial damages without proof of actual damages. Subcommittee members cannot make up their minds either on whether the trader rule lives on or not.

## *DELAYED RETURN*

To keep commercial paper transactions current, the Code imposes time limits on both collecting and payor banks. These are the "midnight deadlines" of U.C.C. sections 4-212 and 4-302. The midnight deadline essentially is midnight

*Bank Deposits and Collections, and Letters of Credit,* 37 Bus. Law. 973, 991 (1982) and commented on Note, *Banks and Banking: "Wrongful Dishonor" Under the UCC—Does It Apply in the Case of a Rightful Dishonor With a Wrongful Notice?,* 35 Okla. L. Rev. 590 (1982). However, as one subcommittee member notes, the reason given in the *Raymer* case was probably less disparaging than the real reason, which may have influenced the court.

201. 438 A.2d 262 (Me. 1981).

202. 640 P.2d 953, 32 U.C.C. Rep. Serv. (Callaghan) 508 (Okla. 1981).

203. U.C.C. § 4-402.

204. An interesting aspect of the case is that it involved a refusal to honor a savings withdrawal slip, which the court held was an "item." Section 4-402 deals with the wrongful dishonor of an item, defined in § 4-104(1)(g) as any instrument for the payment of money. One subcommittee member questions whether the slip should be considered an item.

205. 536 F. Supp. 1271, 34 U.C.C. Rep. Serv. (Callaghan) 230 (D. Mass. 1982).

206. Under § 4-402, when the dishonor occurs through mistake, liability is limited to actual damages proved.

207. 623 P.2d 464, 31 U.C.C. Rep. Serv. (Callaghan) 1677 (Idaho 1980).

208. 29 U.C.C. Rep. Serv. (Callaghan) 1340 (Idaho 1979), discussed in Miller, *Annual Survey —Commercial Paper, Bank Deposits and Collections, and Letters of Credit*, 37 Bus. Law. 973, 991 (1982).

of the next banking day after the banking day of receipt.[209] However, in the case of a collecting bank, the bank may have a longer time after it learns the facts, if it can establish that the longer time is reasonable.[210] In *Southern Cotton Oil Co., Inc. v. Merchants Nat'l Bank*,[211] the item involved was a sight draft drawn by a seller on the buyer and the bank of the buyer. The court on these facts classified the bank as a collecting bank,[212] and thus concluded it was not accountable as long as it gave notice of dishonor by the buyer within a reasonable time, even though that was beyond its midnight deadline. The bank was able to establish that prior dealings had allowed from nine to forty-five days for notice, and so the court did not believe fifty-two days in the case was excessive.

In the case of a payor bank, essentially the only flexibility is to delay the start of the clock. One way to do that is to argue that the location that first received the item for processing is a separate bank so as to have its own additional time period. This may depend in part on what form of U.C.C. section 4-106, dealing with branches as separate banks, the state has adopted,[213] or whether it has adopted a form of section 4-106 at all.[214] But there are more than branches out there today. In *Lufthansa German Airlines v. Bank of America*,[215] the court held that a "centralized returned items" location that performed only sorting and routing and not bookkeeping services for the branches of a bank was not a branch. The court in *Central Bank v. Peoples Nat'l Bank*[216] reached a similar conclusion about a computer center that was physically separate from the branch on which the check was drawn but which the court believed was an integral functional part of that branch. The court held the midnight deadline ran from presentation of the item at the center.

Several years ago *Idah-Best, Inc. v. First Security Bank*[217] was decided. The court held that a data processing center, which adjusted balances, gave provisional credits, and listed insufficient funds checks and certain other checks was tantamount to a collecting bank. Thus the midnight deadline of the payor bank did not begin until the item got to the branch on which it was actually drawn, which alone could make final decisions as to payment. The courts in *Catalina Yachts v. Old Colony Bank & Trust Co.*[218] and in *Bon Bon Productions, Ltd. v. Xanadu Productions, Inc.*[219] essentially adopted that reasoning in holding that presentment of a check at bank *A* for computer processing pursuant to an

209. U.C.C. § 4-104(1)(g).

210. U.C.C. § 4-212(1).

211. 670 F.2d 548, 33 U.C.C. Rep. Serv. (Callaghan) 632 (5th Cir. 1982).

212. *See* U.C.C. § 4-105, comments 2, 3.

213. In essence, the choice is between whether separate books are or are not needed to achieve separate status.

214. For example, Oklahoma did not enact § 4-106 as it does not permit branch banking.

215. 652 F.2d 835, 31 U.C.C. Rep. Serv. (Callaghan) 1426 (9th Cir. 1981).

216. 401 So. 2d 14, 31 U.C.C. Rep. Serv. (Callaghan) 1428 (Ala. 1981).

217. 584 P.2d 1242 (Idaho 1978), commented on in Bailey, *Annual Survey—Commercial Paper, Bank Deposits and Collections, Letters of Credit*, 35 Bus. Law. 1129, 1137–38 (1980).

218. 497 F. Supp. 1227, 32 U.C.C. Rep. Serv. (Callaghan) 241 (D. Mass. 1980).

219. 32 U.C.C. Rep. Serv. (Callaghan) 253 (D. Mass. 1981).

agreement between the banks did not constitute the receipt of the check by bank *B*, the payor, and therefore the payor's midnight deadline did not begin to run until bank *B* physically received the check.

These cases raise difficult issues and the Code, being drafted before the development of the technology that gave rise to them, does not furnish a clear answer. Arguably, the *Central Bank* case is in error since a collecting bank has its own midnight deadline[220] and presentment, as a demand for payment, should be considered to be made only when the item is received by a person who can make or refuse payment,[221] something which a data processing center cannot do. But subcommittee members are not entirely convinced that the policy of the *Central Bank* case is not the sounder policy. Certainly these cases indicate an issue that should be considered by any bank engaging in off-premises data-processing activities.

If the midnight deadline is passed, certain excuses are possible according to section 4-302. One that has had some success is computer failure. Section 4-108(2) allows as an excuse circumstances beyond the control of the bank, provided the bank exercises the diligence the circumstances require. This provision received a strict construction in *Congress Factors Corp. v. Extebank*,[222] where the cause was a power failure, but the court denied relief on the grounds the bank had not developed any alternative for such a case, even though there had been prior power failures and the bank had chosen a system that required hours to restart even in the case of the briefest outage. Subcommittee members commenting on the case tended to be bothered by the harshness of this result, especially as it might be applied to small banks with limited resources.

Most subcommittee members, however, approved the latest case in the split of authority over whether a once-presented and dishonored check must have another notice of dishonor within the midnight deadline if it is represented. The court in *Prestige Motors, Inc. v. Carteret Bank*[223] joined the majority of courts in answering yes on this issue.[224]

Finally, we can conclude with *Bank Leumi Trust Co. v. Bally's Park Place, Inc.*[225] A big loser at a gambling casino drew a counter check for his $60,000 losses. He expired shortly thereafter with a $5000 estate. The casino tried to collect directly against the estate and learned these facts. Apparently with the philosophy "nothing ventured, nothing gained," it then put through the check for payment by the drawee even though the account had been closed for two months. The bank ran past the midnight deadline. The court said sections 3-418 (final payment) and 4-301 and 4-302 (accountability for going past the

220. U.C.C. § 4-212.

221. U.C.C. § 3-504.

222. 32 U.C.C. Rep. Serv. (Callaghan) 1559 (N.Y. Civ. Ct. 1982).

223. 444 A.2d 627, 33 U.C.C. Rep. Serv. (Callaghan) 1438 (N.J. Super. Ct. 1982).

224. The minority view is articulated in Leaderbrand v. Central State Bank, 450 P.2d 1, 6 U.C.C. Rep. Serv. (Callaghan) 172 (Kan. 1969). Of course, if the bank has an actual agreement with the owner of the item to hold the check for a hoped arrival of funds, liability should be avoided.

225. 528 F. Supp. 349, 32 U.C.C. Rep. Serv. (Callaghan) 1542 (S.D.N.Y. 1981).

midnight deadline) apply only to interbank settlement procedures and not to subsequent actions for restitution by a payor bank. Thus, the law of mistake was held to be applicable through section 1-103. The opinion is a good example of bootstrapping, if nothing else. All subcommittee members commenting on the case think justice was done, but worry whether some certainty in commercial law was undone. Perhaps, but the facts simply seem a classic case for invoking the obligation under section 1-203 of good faith.