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HARVARD LAW REVIEW

THE RISK FIXERS

Hal S. Scott *

Novel legal problems presented by the recent emergence of new payment systems have prompted some to call for revision of article 4 of the Uniform Commercial Code. Others suggest that private contract can deal with the issues raised by most new commercial transactions. In this Article, Professor Scott examines the emergence of the first banking code in order to explain why private contract did not develop to govern payment transactions. He suggests that commercial statutes have been not as much embodiments of the law merchant as devices for allocating risk among transactors. Drawing on this historical analysis, Scott identifies a number of factors present in the new payment systems which may lead to the adoption of new risk-fixing commercial legislation.

THERE is no real jurisprudence of commercial law. We are presently prisoners of the conception that commercial law embodies the law merchant and that the Uniform Commercial Code merely furnishes businessmen with a clear statement of their rules. In the public writings of Karl Llewellyn, the Chief Reporter of the U.C.C., we find the Code justified primarily as a backstop for private contract; [1] substantive intrusion, to the extent that it occurred, was intended only to eliminate irrational inconsistencies created by misguided courts or legislatures. Even Grant Gilmore's historical approach, which does not treat the Code as merely incorporating merchant practices, is only a step removed from Llewellyn's basic conception. Gilmore, the principal draftsman of article 9, sometimes refers to provisions of that article as responsive to particular commercial interests, but he attempts to explain the statute as a rational curative for the difficulties presented by the disparate common law and statutory security interests of the past.[2] This widely accepted "law mer-

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[1] *See* Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROB. 687 (1948); Llewellyn, *Why a Commercial Code?*, 22 TENN. L. REV. 779 (1953); Llewellyn, *Statement to the New York Law Revision Commission, A Simple Case on Behalf of the Code*, in 1 NEW YORK LAW REVISION COMM'N, STUDY OF THE UNIFORM COMMERCIAL CODE 5 (1954). *See also* Llewellyn, *Why We Need the Uniform Commercial Code*, 10 U. FLA. L. REV. 367 (1957).

[2] *See* 1 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY 1–294 (1965); Gilmore & Axelrod, *Chattel Security* (pt. 1), 57 YALE L.J. 517 (1948). The

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chant" view of commercial law has produced a body of commentary on the Code which might properly be classified within the French literary school of *explication de texte*. Commercial law has become largely the province of the adept reader of statutes, and the methodology of the Code is the skill of working out language puzzles.

There is, in my view, a need to develop two lines of analysis in the field of commercial law. First, we should inquire why private contract and the common law of contract did not prove a sufficient basis on which to organize a commercial law. Here, a historical approach that tries to account for the development of statutory law is most useful. A second and related inquiry, not undertaken here, would evaluate the desirability of a particular statutory rule by assessing the rule's asserted regulatory objective — *i.e.*, to cure market imperfections or abuses — and its distributional impact on market actors.

This Article pursues the first inquiry by attempting to explain the origins of statutory rules for check collection. While checks became a prominent form of payment in the nineteenth century, it was not until the adoption of the American Bankers' Association Bank Collection Code (ABA Code) in the 1920's that there was any significant legislative activity in the field.[3] Our historical inquiry will focus upon this statute, which, as the first major statute governing check collection, was a direct ancestor of article 4 of the U.C.C., rather than upon the U.C.C. itself, which is the usual subject of commercial law analysis. Indeed, to confine the scope of inquiry to the U.C.C. and to ignore that it is but a variation on a preexisting statutory theme often means that the basic question of the need for statutory provisions is never broached.

My thesis is that the need to backstop private contract or to provide "rational" ordering is not a sufficient explanation for statutory development. Statutory commercial law rules are instead to be understood as largely regulatory in import. Some rules deal with cases where private contract actually fails to structure risk allocation or fails to structure it efficiently. Other rules are enacted to rid merchants and financial institutions of common law restraints on contract or to eliminate the competition accompanying contractual freedom. Still others may be enacted at the insistence of consumers to limit the contractual

perceived need for a rational ordering of prior law is reflected in other works by Professor Gilmore.

[3] *See* 10 C. ZOLLMANN, THE LAW OF BANKS AND BANKING 555–69 (1936) (reproducing the Code). There were, however, some earlier state statutes. *See* Pierson, *Legislation Relating to the Problem of Check Collection*, 14 A.B.A.J. 406 (1928).

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freedom of merchants. In any case, statutory rules are principally designed to alter rather than to "codify" the existing legal regime. They reflect concern with the ability of various transactors, whether merchants or consumers, to protect themselves in the marketplace, and they are ultimately distributional in character. Since they are designed to alter the existing order or to remedy market failure or inefficiency, statutory commercial rules are unlikely to be optional — mere backstops for existing merchant practices. Even optional rules designed to provide a legal rule in the absence of private contract will become more than backstops. The parties to a transaction may accept optional statutory provisions — whether or not they conform to merchant practice — because the cost of contracting out of them is greater than the efficiencies that might be achieved through such variation.

The first two Parts of the Article attempt to set the background for the regulatory impulse evidenced in the ABA Code. Part I describes how nineteenth-century courts overrode bank depositor contracts so as to shift significant risks involved in the collection of checks onto banks. Banks compensated for the additional risks by increasing the discount charged to depositors for check collection. Price fixing limited attempts by individual banks to reduce the discount by effecting economies with respect to such risks.

Part II explains how entry of the Federal Reserve Banks into check collection, in response to price fixing and cartel activities of the banks, eventually created a "risk differential" between banks collecting checks through the Federal Reserve System and those using alternative collection arrangements. The nineteenth-century court decisions compounded the significance of these differentials. An attempt to eliminate the disparity through an ABA-sponsored standard form contract failed.

In Part III, we look at the ABA Code itself. Section A argues that the Code was an attempt to achieve by statute what could not be achieved through the standard form contract. The object of the Code was to impose the same collection risks on all banks and to shift many risks to depositors by reversing the nineteenth-century court decisions. The commercial statute was thus the last act in a historical drama in which competitors successively chose different means to limit their competition in risk allocation. It was enacted because other means of limiting competition, price fixing and risk fixing by private agreement, could not deal with the risk distortion introduced by the courts and the Federal Reserve System. Other functions performed by the ABA Code and associated payment rules — solutions to third-party problems

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and achievement of scale efficiencies in risk allocation — are examined in Sections B and C respectively. Following this analysis of the ABA Code as an essentially regulatory endeavor, Section D offers a brief critique of the more traditional justifications for a commercial statute — the need for uniformity and a backstop for contract.

Part IV then seeks to apply the lessons learned from the development of statutory rules for check collection to a currently debated question. Since enactment of the ABA Code in the 1920's and its development into article 4 of the U.C.C. in the 1960's, technology has spawned new payment systems (NPS) — credit cards and various forms of electronic fund transfers. Although it can be argued that article 4 rules could apply to such transactions,[4] these forms of payment present significant new problems in the allocation of collection risks that article 4 neither identifies nor solves. As a result, collection risks in these systems are structured today by private agreements. Section IV argues that factors similar to those which led to statutory law for checks will lead to statutory law for new payment systems. Private contract will not be permitted to stand merely because it can allocate risks effectively or because no law merchant has yet developed in the area.

I. Check Collection in the Nineteenth Century

The earliest form of check collection within a given city was by messenger. When a check drawn on bank *A* was deposited in bank *B*, a messenger from *B* would present the check for payment over the counter at *A*. After the check was examined — for authorized signatures, sufficient funds, or stop-payment orders — *A* would either pay the messenger in specie or credit *B*'s account at *A*. At the same time, checks held by bank *A* and drawn on bank *B* would be delivered to the messenger on the spot and "cleared" through a provisional offset against the funds owing to *B*. The items would be returned to *B*'s officials, who would decide whether to pay them. If the items were not returned to *A* within a fixed period of time, they would be "collected"; the settlement between the banks became final. If *B* decided not to pay certain items, they would be returned according to the custom of protest and a credit reversing the debit to *B* would be entered on *A*'s books.[5]

Over-the-counter presentation generally was not used for

[4] *See* Clarke, *An Item Is an Item: Article 4 of the U.C.C. and the Electronic Age*, 25 Bus. Law. 109 (1969).

[5] *See* W. Spahr, The Clearing and Collection of Checks 67–73 (1926).

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out-of-town checks because of the expense of sending an agent to collect on a distant payor bank. Instead, "correspondent" relationships furnished the collection network. Correspondence was an arrangement by which banks settled their accounts by ledger, using either periodic specie shipments or debits to deposit balances held by another bank in order to cover adverse balances. Correspondent relationships developed in order to avoid "exchange" — remittance charges by payor banks for check collection. In the 1800's, an out-of-town check mailed directly to the payor-drawee bank was not paid at "par," the face value of the check. In the 1830's, for example, remittance charges on checks could be up to 1.5% of the face amount of the check.[6] If the check was presented over the counter, however, the depositor's contract and common law rules required the drawee bank to pay at par.[7] As a result, banks collecting out-of-town checks looked for an intermediate bank near the drawee to present items over the counter. The intermediate bank charged no remittance fee for this service if the collecting bank had established a correspondent relationship with it by leaving an interest-free deposit to cover the actual costs of collection. A correspondent was needed at every step of the collection process. If a depositary bank in New York wished to avoid exchange for collecting an item on a Chicago bank, it might send the item to its correspondent in Cleveland, which would remit at par. The Cleveland bank would send the item to its own correspondent in Chicago, which would remit at par to the Cleveland bank and in turn present the item over the counter to the Chicago drawee bank for par payment.

A. The Theoretical and Practical Adequacy of Contract to Structure Check Collection

The legal foundation of this collection system was contract. The depositor-payee of the check had a contract with the depositary bank either by general agreement or under a printed legend on the deposit receipt. The collecting bank had a correspondent agreement with its intermediate or payor banks, and the payor-drawee bank had a general contract with its drawer. Until correspondence agreements from this period are unearthed, we cannot know the extent to which they apportioned the significant risks of collection between banks. With respect to bank-depositor relationships, risk clearly was apportioned by custom, contract, and a growing common law. The risk for paying an item

[6] *See id.* at 102.

[7] *See* Wiley v. Bunker Hill Nat'l Bank, 183 Mass. 495, 67 N.E. 655 (1903), and authorities cited therein.

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on which the drawer's signature was forged, for example, fell on the bank both under well-established custom and under the common law.[8] On the other hand, a bank usually stipulated to its depositor [9] that any credits were subject to collection and that the depositor bore the risk of collection, including losses attributable to acts of intermediary banks or nonpayment by the drawee.

Despite historical uncertainties about the extent to which the contracts underlying check collection explicitly dealt with risks, it is clear that these contracts could have apportioned all significant risks. The relevant parties were usually in contractual privity, and the volume of transactions probably justified the expense of contract. Even where an intermediate correspondent bank presented an item over the counter to a drawee bank with which it was not in privity, the drawer-drawee contract set the terms of collection and the intermediate bank was a third-party beneficiary of that contract.

B. Court Interference with Freedom of Contract

Throughout the nineteenth century, common law courts, increasingly solicitous of bank depositors, limited contractual freedom and with it the ability to allocate the significant risks of check collection by private contract. Courts construed contracts against banks,[10] interpreted custom as favorable to depositors or rejected customs favorable to banks,[11] and directly overrode contractual provisions,[12] often saying that a bank could not con-

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[8] *See* J. BRADY, THE LAW OF BANK CHECKS §§ 127, 128 (1915).

[9] Often the "contract" was in the form of a legend printed on a receipt for the item.

[10] *E.g.*, Harter v. Bank of Brunson, 92 S.C. 440, 75 S.E. 696 (1912) (bank could not avail itself of deposit slip legend making deposits subject to collection when it sought to reverse a credit six months after the date of deposit).

[11] *E.g.*, Minneapolis Sash & Door Co. v. Metropolitan Bank, 76 Minn. 136, 78 N.W. 980 (1899). The court in *Minneapolis Sash & Door Co.* did not permit a depositary bank to rely on the custom of mailing checks directly to drawee banks for payment to absolve it of negligence liability for a collection loss attributable to direct sending. "As a general rule, usage and custom will not justify negligence. It may be admitted that such a course is frequently adopted, but it must be at the risk of the sender . . . ." *Id.* at 144, 78 N.W. at 981.

[12] *E.g.*, Bank of Rocky Mount v. Floyd, 142 N.C. 187, 55 S.E. 95 (1906). In *Floyd*, a collecting bank sued both its depositor-payee and its intermediary correspondent bank to recover the loss on a check after the drawee bank had failed. Despite a contractual provision with the collecting bank stipulating remittance to be at the "owner's risk until we receive full actual payment," the intermediate bank was held liable for the item. The court first stated that it "cannot suppose that [the clause] was intended to be understood as releasing the defendant from the consequence of its own negligence," and then stated that "[i]f such is the proper construction of the language, and if, thereby, it is relieved from the re-

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tract out of its own negligence.[13] Through the use of these techniques, risks allocated to depositors by contract were shifted back to the banks; in effect, banks became subject to a number of substantive collection risks.

One such limitation on banks' freedom of contract related to payments to depositors on out-of-state items. Unless a bank most "explicitly" indicated otherwise in its contract with its depositor, such payments were not "subject to collection"; the bank was said to purchase the check upon deposit.[14] Another rule affected a bank's ability to avoid payment on forged checks: if a bank credited a depositor for an "on us" item — one drawn on another customer of the same bank — that entry constituted "final payment," and subsequent discovery of a forgery did not allow the bank to retract the credit.[15]

Judicial definition of the duties of the collecting bank shifted the risk of collecting, at least partially, from the individual depositor-payee to the depositary-collecting bank. Under the "New York rule," a collecting bank was responsible to its depositor-payee for the solvency and diligence of all banks in the chain of collection.[16] Although some cases hinted that the "New York rule" could be changed by contract,[17] courts in "New York rule" states seemed to go out of their way to interpret contracts and usage to avoid this result.[18] Under the so-called "Massachusetts rule" in effect in other states, the depositary bank was responsible to the depositor-payee for only its own negligence, out of which it could not contract. Subsequent banks in the chain of collection were directly liable to the customer for their own negligence.[19]

Another subject of much litigation was the depositary bank's liability to a depositor for the drawee bank's nonpayment of a check presented directly through the mail. Direct forwarding of checks was held negligent per se because of the drawee bank's

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sponsibility for its own negligence, we should not hesitate to hold it unreasonable and invalid." *Id.* at 195, 55 S.E. at 98.

[13] *See* J. BRADY, *supra* note 8, § 194.

[14] City of Douglas v. Federal Reserve Bank, 271 U.S. 489, 493–94 (1926); Taft v. Quinsigamond Nat'l Bank, 172 Mass. 363, 52 N.E. 387 (1899), and cases cited therein.

[15] Levy v. Bank of the United States, 4 Dall. 234 (Pa. 1802).

[16] Federal Reserve Bank v. Malloy, 264 U.S. 160 (1924); Exchange National Bank v. Third National Bank, 112 U.S. 276 (1884); Youmans Jewelry Co. v. Blackshear Bank, 141 Ga. 357, 80 S.E. 1005 (1914); Harter v. Bank of Brunson, 92 S.C. 440, 75 S.E. 696 (1912).

[17] *See* Exchange National Bank v. Third National Bank, 112 U.S. 276, 281 (1884).

[18] *See* Harter v. Bank of Brunson, 92 S.C. 440, 75 S.E. 696 (1912).

[19] *See* Federal Reserve Bank v. Malloy, 264 U.S. 160, 164 (1924).

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conflict of interest when asked to collect against itself. Courts thought it only prudent to present checks through a correspondent who could get prompt payment over the counter.[20] Judicial uneasiness with direct forwarding might have related to the absence of a contractual underpinning for the payment. Not only was the drawee being asked to collect against itself, it had no obligation other than an unclear customary one to remit to the presenting bank.

If banks sought to avoid liability for direct forwarding and to minimize exchange premiums by collecting only through correspondents, they could get into trouble for circuitous routing. This is illustrated by the decision in *First National Bank v. Miller*.[21] The defendant First National Bank of Wymore received the plaintiff's checks for deposit, indorsed in blank, on a Saturday. The checks were drawn on the State Bank of Cortland which was twenty-seven miles away. Defendant, apparently having no regular correspondent in Cortland, mailed the checks to a bank in St. Joseph, Missouri, which forwarded the checks to the Omaha National Bank, which in turn sent them to the Cortland bank, where they arrived on Thursday, by which time the drawer had become insolvent. If the checks had been directly forwarded to Cortland, they would have arrived on Monday, at which time there were sufficient funds to cover the items. After the Wymore bank applied the balance in the plaintiff's account to the unpaid amount of the items, plaintiff sued to recover the balance and the Wymore bank counterclaimed on his indorsement contracts for the amount allegedly remaining due. The Supreme Court of Nebraska affirmed the trial court's judgment for the depositor. The Wymore bank's counterclaim was disallowed because the checks, owing to their circuitous routing, had not been presented to the Cortland bank within a reasonable amount of time. Since circuitous routing was viewed as negligent, the depositary bank was not permitted to rely upon the plaintiff-depositor's indorsement contract; its attempt, in other words, to contract out of the risk of nonpayment by the drawee bank was to no avail.[22]

Finally, despite custom or contract to the contrary, banks

[20] German Nat'l Bank v. Burns, 12 Colo. 539, 21 P. 714 (1889); Minneapolis Sash & Door Co. v. Metropolitan Bank, 76 Minn. 136, 78 N.W. 980 (1899); Bank of Rocky Mount v. Floyd, 142 N.C. 187, 55 S.E. 95 (1906).

[21] 37 Neb. 500, 55 N.W. 1064 (1893). *See also* Gifford v. Hardell, 88 Wis. 538, 60 N.W. 1064 (1894).

[22] The court added that it was immaterial whether the method the Wymore bank had used to present the checks was the customary practice of bankers: "[W]e do not think that bankers, by any custom, can evade their legal duties." 37 Neb. at 505, 55 N.W. at 1065.

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were liable for accepting anything but specie or deposit balances in settlement for items paid by drawee banks. It was also negligent for depositary banks to accept bank drafts as payment in remittance from intermediate banks.[23]

Throughout the nineteenth century, then, courts were shifting risks onto banks which the banks could not shift back to the depositor through contract or which they could shift back only with great difficulty.[24] It is my contention that the banks did not view this development with particular alarm. Although there is presently little evidence on this score, one can observe that there was no attempt to undo these decisions through statute until the 1920's. My guess is that the banks compensated for the risks imposed by the courts through the exchange charges available in the nonpar collection system. Any risk was offset through increasing charges to the depositor in order to cover the total harm attributable to the liability discounted by its probability of occurring. While it might have been more efficient for depositors to assume certain risks, the banks were indifferent as long as all competing banks within a state were under an equal disability to contract and the substitution of other payment systems was not possible.

C. Centralization of Collection and Price Fixing

While these legal developments were taking place, the evolving role of the clearinghouse was changing check collection procedures. In 1853, New York opened the first clearinghouse for in-city collections. Prior to that time, the fifty-two banks in the city kept deposits with each other, and bilateral deposit settlement occurred once a week. The clearinghouse offered a multilateral net settlement device to replace the bilateral system of the past. Banks met each other daily, and each netted out against all others. In the early days of the New York Clearing House, the debtor banks brought specie, but later accounts were settled through a clearing account held in one bank. In other cities, the clearinghouse itself received payment and paid the creditor

[23] Federal Reserve Bank v. Malloy, 264 U.S. 160 (1924); Bradley Lumber Co. v. Bradley County Bank, 206 F. 41 (8th Cir. 1913); National Bank of Commerce v. American Exch. Bank, 151 Mo. 320, 52 S.W. 265 (1899); Nunnemaker v. Lanier, 48 Barb. 234 (N.Y. Sup. Ct. 1867).

[24] Commentators often held out hope that the contract would stand up if it were clear enough. *See, e.g.*, Note, *Bank Stipulations to Avoid a Presumption of Purchase in Collection Cases*, 27 COLUM. L. REV. 73, 75–76 (1927) (citing cases in support of this proposition, though all but one of the cases actually read the contract in favor of the depositor).

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banks, or the clearinghouse manager drew against the debtor banks in favor of the creditor banks.[25]

Clearinghouses did not take a role in out-of-town collection for some time, however. Their entry appears to have been stimulated when interbank competition for deposits led to the diminution of collection charges to depositors.[26] Banks which attracted deposits by decreasing collection charges aimed to make a better return by the use to which they put these deposits. Ultimately, the ability to compete on collection was a function not only of running the cheapest collection service but of making the highest returns in the normal banking business. It was still true, however, that some banks were cheaper collectors because of lower correspondence charges and efficiency in avoiding loss. Other banks sought to neutralize this competitive advantage by extending the activities of the clearinghouses to out-of-town collection. The Boston and New York Clearing Houses, which led the way, adopted different solutions.

In 1899, the Boston Clearing House (BCH) created a foreign collection department to handle all out-of-town items deposited in member banks.[27] The Clearing House offered various advantages. First, it centralized the paperwork for out-of-town collections into one department.[28] Second, the BCH gave its manager full power to decide which banks to use for collection in any given area. The prospect of the entire out-of-town collection for Boston allowed BCH to negotiate down the exchange charges for direct forwarding.[29] Alternatively, the BCH could negotiate the best possible terms on settlement balances with its correspondents. In fact, the BCH, and in turn its members, secured par return from ninety percent of the banks in New England.[30] Finally, BCH members agreed to charge their depositors a prescribed minimum collection fee — which could not

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[25] *See* Andrews, *The Operation of the City Clearing House*, 51 YALE L.J. 582 (1942).

[26] *See* J. CANNON, CLEARING-HOUSES: THEIR HISTORY, METHODS AND ADMINISTRATION 64 (1900). Cannon, who became president of the Fourth National Bank of the City of New York, apparently felt that the competition among banks that resulted in their bearing the cost of collecting out-of-town items was intolerable, for he argued that "[a] remedy for this injustice seems impossible so long as there is no concert of action among the banks." *Id.*

[27] *See* J. THRALLS, THE CLEARINGHOUSE: ITS ORIGIN, DEVELOPMENT, FUNCTIONS, OPERATIONS, METHOD, PLANS AND SYSTEMS 15–22 (1916); J. CANNON, *supra* note 26, at 248–251.

[28] *See* J. THRALLS, *supra* note 27, at 21.

[29] "Strength, service and rates are the principal factors in determining . . . to what bank, or banks, the Country Clearing House will send its items on towns wherein there are two or more banks." *Id.* at 16.

[30] *Id.* at 21.

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be circumvented by rebates or any form of compensation — for out-of-town items not paid at par by payors.[31] The New York Clearing House (NYCH) also entered the field of out-of-town check collection in 1899. It too fixed uniform charges for collection, although it is unclear whether these applied only to non-par collections.[32] The NYCH system did not, however, undertake to centralize check collection.

Price fixing on charges was quite common in 1913.[33] Some clearinghouse associations went even further and fixed interest rates on loans.[34] Such ancillary restraint appears the natural result of attempting to enforce regulation of collection charges. Without fixed interest rates, banks would rebate in lower interest rates what they were required to charge for collection.

As of 1913, it was quite possible that out-of-town collection would continue to evolve through the clearinghouses. Further, the fixing of collection charges greatly mitigated the possible adverse consequences of the collection liabilities that courts had imposed on banks. As long as banks agreed to charge a minimum amount on collection, they did not have to worry a great deal about competitors' bidding away depositors by efficiently reducing court-imposed collection risks.

II. Check Collection After the Enactment of the Federal Reserve Act of 1913

The entry of the Federal Reserve Board (the Fed) into the check collection process, largely to curb the power of the private clearinghouses, created different schedules of costs and risks for banks which collected through the Fed and those which did not. Subsidized par collection through the Fed system reduced the costs of collection to participant depositary banks and their customers. The fully elaborated Fed regulations also allowed participants to shift the major risks of collection to their depositors or to the public which subsidized the Fed itself. The risk differential introduced by Fed collection became a significant factor in competition between banks. The ABA Code, the first major collections statute, was enacted in response to these competitive pressures.

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[31] J. Cannon, *supra* note 26, at 249.

[32] *See* W. Spahr, *supra* note 5, at 126; D. Hoffman & M. Miller, Origin and Development of Charges for Banking Services 14 (1942).

[33] James G. Cannon, *see* note 26 *supra*, testified at the Money Trust Investigation of 1913 that 91 of the 242 clearinghouse associations in the country fixed collection charges. *Money Trust Investigation: Hearings Before a Subcomm. of the House Comm. on Banking and Currency Reform*, 62d Cong., 3d Sess. 216, 218 (1913).

[34] *Id.* at 158.

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A. The Federal Reserve Act as Reaction to Clearinghouse Price Fixing

If the Federal Reserve Act of 1913 [35] had not been passed or the Federal Reserve Banks had not been given authority to act as "switches" for out-of-town collection, we might have evolved a collection system run by the private clearinghouses and a national association of clearinghouses.[36] Section 16 of the Federal Reserve Act,[37] however, gave the Federal Reserve Board authority to make each Federal Reserve Bank (FRB) a clearinghouse for intradistrict clearings among its member banks and authorized the Federal Reserve Board itself to handle interdistrict clearance between FRB's.

Unwillingness to rely on a bank cartel as a solution for check collection inefficiencies contributed to the authorization of a central role for FRB's in the collection process. Enacted against the backdrop of the "Money Trust Inquiry" of the House of Representatives in 1912 and 1913, the check collection provisions of section 16 were aimed at the abuses perpetrated by the private clearinghouse associations.[38] Fear of the cartel, however, was not the only reason for the provisions. Control of clearing by the FRB's was seen as a way to make member bank reserves a useful tool rather than an idle fund held for possible emergencies. Finally, the inefficiencies in the existing check collection system suggested the benefit of further centralizing foreign collection.[39]

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[35] Federal Reserve Act, ch. 6, 38 Stat. 251 (1913) (codified in scattered sections of 12, 31 U.S.C.).

[36] The Clearing-House Committee of the American Bankers' Association had already acted to secure uniformity in the operations of different clearinghouse associations.

[37] Federal Reserve Act, ch. 6, § 16, 38 Stat. 251 (1913) (current version at 12 U.S.C. § 248(o) (1970)).

[38] *See* H. WILLIS, THE FEDERAL RESERVE SYSTEM: LEGISLATION, ORGANIZATION, AND OPERATION 109, 145 (1923).

[39] *See id.* at 1054.

One commentator argued that the defects in the old interregional check collection system which gave rise to the Federal Reserve System of clearing and collection included (1) excessive charges, (2) indirect routing of checks to avoid remittance charges, (3) immediate credit for uncollected funds, (4) interest payments on uncollected funds, (5) compensating balances left with collecting banks solely to obtain par payment, (6) maintenance of reserve balances with banks for the sole purpose of getting items on which to charge exchange, (7) excessive gold movements, and (8) absorption of collection charges by collecting banks. W. SPAHR, *supra* note 5, at 101–02. There is no evidence, however, that these features of the system were responsible for federal intervention. In fact, many of them were being eliminated by the use of the clearinghouses for out-of-town collection.

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B. The Fed Collection System: Subsidized Par Collection

1. Par Collection System. — A primary objective of Federal Reserve Board policy was to eliminate the exchange which drawee banks charged on remittances. There was a direct relationship between these remittance charges and the collection fees charged depositors by collecting banks: the more the remitting bank charged in exchange to the collecting banks, the higher the collection charges of the latter would be. Collecting banks had attempted to minimize exchange charges by collecting through correspondents with eventual over-the-counter presentation and payment at par, but to the extent this was not possible, the exchange charges remained and affected the collection charges to bank customers.

It was an odd feature of the nonpar system that the merchant seller of goods paid the costs of collection, since it was the buyer who was contributing to collection costs by paying with an out-of-town check. But given the inability of the merchant to price goods at differential rates, according to the medium of payment, inefficiency in the choice of payment media by buyers must have occurred. A premium collection system, in which each bank charged each subsequent bank for collection costs with an ultimate charge to the drawer, might have eliminated this problem. It is not altogether clear why such a system did not emerge. In any event, the push for par collection in large part reflected the demand of merchants that they should not pay significant collection charges and that instead such costs should be shared by depositors of all banks.[40]

As originally enacted, section 16 of the Federal Reserve Act seemed to authorize the Board to fix member banks' collection charges for items cleared through the Fed system; the Board, however, did not do so, and members worked on the assumption that they could charge any "actual expense" of collection.[41] But

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[40] The major advocates of a par collection system were merchant groups such as the National Association of Credit Men and the United States Chamber of Commerce. *See* W. SPAHR, *supra* note 5, at 240 & n.14.

[41] The original § 16 of the Federal Reserve Act provided that

> [n]othing herein contained shall be construed as prohibiting a member bank from charging its *actual expense* incurred in collecting and remitting funds, or for exchange sold to its patrons. The Federal Reserve Board shall, by rule, fix the charges to be collected by the member banks from its patrons whose checks are cleared through the Federal reserve bank and the charge which may be imposed for the service of clearing or collection rendered by the Federal reserve bank.

Ch. 6, § 16, para. 13, 38 Stat. 251 (1913) (emphasis added). As is made clear in paragraph 8 of Regulation J, series of 1916, the Board thought that the statute authorized it to fix only the exchange charges imposed by member banks. *See*

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the heart of the par controversy was not whether member collecting banks could charge their customers for collection; rather, it was whether member banks could charge the FRB's exchange. The country banks in particular opposed eliminating exchange charges.[42]

When comparatively few member banks opted to use a voluntary reciprocal par collection system,[43] the Federal Reserve Board in July 1916 established compulsory par collection. This system contained the essentials of the collection scheme that was to last through the 1920's. The key to the system was the requirement that member banks remit at par for all checks presented to them directly through the mail by the FRB's. Members were also required, in most cases, to collect out-of-town items through the FRB's. The FRB's would accept at par all checks presented by members, except those drawn on nonmember banks that did not pay par on items presented through the mail. Immediate book credit was given, though credits did not count as reserves until the items were finally collected.

A September 1916 amendment to section 13 of the Federal Reserve Act authorized FRB's to collect on nonmember banks,[44] but nonmembers could still refuse to accept checks at par. Nonmembers consistently objected to par collection because it forced them to pay exchange for collections from member banks and to remit at par to the FRB when collection went the other way.[45] The Hardwick amendment of June 1917 removed the one-way-street objection by authorizing the Federal Reserve to receive "solely for purposes of exchange or of collection . . . from any nonmember bank or trust company . . . checks and drafts pay-

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G. Anderson, The Federal Reserve Check Collection System 12–18 (1917) (on file at Widener Library, Harvard Univ.) (containing text of Regulation J).

[42] G. Anderson, *supra* note 41, at 59–72; W. SPAHR, *supra* note 5, at 232–33; H. WILLIS, *supra* note 38, at 399–406.

[43] *See* G. Anderson, *supra* note 41, at 8.

There were two periods in the early history of the Federal Reserve's attempt to achieve par collection: June 1915 to July 1916, the "voluntary system," and after July 1916, the "involuntary system." Under the voluntary system FRB's would give immediate par credit for checks deposited by members drawn on an assenting drawee member bank's account, subject to payment by such member bank. This became known as the reciprocal plan of immediate clearing. It was up to members whether or not they wished to use the system. Comparatively few did, principally because the system could accommodate only items drawn on other assenting members.

[44] Act of Sept. 7, 1916, ch. 461, 39 Stat. 752.

[45] By December 15, 1916, only 37 of approximately 20,000 state banks had become members of the Federal Reserve System and only 8,065 of the nonmember banks had assented to par clearance. *See* Farmers & Merchants Bank v. Federal Reserve Bank, 262 U.S. 649, 655 (1923).

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able upon presentation."[46] Nonmembers could, therefore, "participate" in the Federal Reserve collection system by establishing an FRB clearing account. Although not entirely clear from the statute, nonmember bank collection through the Fed was payable at par only if the nonmembers in question agreed to remit at par for FRB collection of items drawn on them.[47] Thus, the clearing privilege was still of limited value to nonmembers who were in deficit positions on nonmember clearings — *i.e.*, those banks which were drawn on more than they collected items drawn on others. Money saved at the front end of collection did not compensate for forgone "exchange."

The Hardwick amendment also made it clear that both member and nonmember banks still could make limited "exchange" charges — not to exceed ten cents per $100 or fraction thereof of a total collection — for non-Fed collections. Payor members had little opportunity to assess such charges since no collecting member could make out-of-town collections outside the Fed without getting authorization. Nonmember participants, however, could collect their items outside the Fed system at will. The effort of some banks to get Congress to provide for a standard remittance charge for all collections, including those through FRB's, failed.[48] The effects of limiting exchange for non-FRB collection were mixed. It encouraged nonmember banks to submit to par collection by preserving their ability, once having submitted, to charge exchange on non-FRB collections. By encouraging other nonmembers to collect through FRB's in order to avoid these same exchange charges, however, it reduced the possibility for exchange and with that the advantage of being a nonmember participant.

As of 1918, then, banks faced the following situation in interdistrict collections. Member banks could collect at par through the FRB's on members, participant nonmembers, and nonparticipants who agreed to pay par to the FRB. They could also elect, with the approval of the local FRB, to send an item directly to participants and pay a charge limited to ten cents per $100.[49]

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[46] Act of June 21, 1917, ch. 32, § 4, 40 Stat. 232.

[47] The Fourth Annual Report of the Federal Reserve Board (1918) [hereinafter cited as Fourth Annual Report] states:

> Section 13 of the act was amended last June as recommended by the Board, so as to allow Federal Reserve Banks to receive accounts for collection and exchange purposes from such nonmember banks and trust companies *as may agree to remit to Federal Reserve Banks at par* for checks drawn upon themselves . . . .

Id. at 23 (emphasis added).

[48] *Id.*

[49] W. SPAHR, *supra* note 5, at 191–92. *See also* 6 FED. RES. BULL. 494 (1920) (ruling that direct collection on a participant with remittance to the Federal

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This alternative was often approved when collection through the FRB proved more circuitous, but total collections of this type were small. Items drawn on nonparticipants not paying at par were collected outside the FRB's. However collected, the member bank was free to charge its customer for collection. When member banks were drawn on by other member banks or participating nonmember banks, they were required to pay at par if the item came through the Federal Reserve and to charge no more than ten percent if the item came directly, with FRB approval, from participants. If, on the other hand, members were drawn on by a nonparticipant, they could charge whatever "exchange" the market permitted. The nonmembers who became Federal Reserve participants faced the same set of constraints, albeit with more latitude to use non-Fed collection on other participants. Nonmembers who did not become Fed participants could generally charge any rate the market permitted.

If the system had remained this way, it is far from clear that competition would have eliminated exchange and collection charges or that participant banks would have charged depositors less for collection than did nonparticipants. Participating banks were still paying exchange on non-FRB collections and certain collection costs on FRB collections. Given these incurred charges, participants were unlikely to abandon the collection charge to depositors. Moreover, court-imposed commercial risks remained, and some of the clearinghouse rules requiring minimum charges were in effect even after 1914.[50]

Nonparticipants could charge at least whatever participants were charging for collections, but given their exchange business, they could also charge somewhat less. They might use exchange profits as a cross-subsidy to attract depositors. As between two country banks in a district, one a participant and one not, the nonparticipant might make more in exchange than the member saved its customers by par collection.

Reserve was not collection through the Federal Reserve; thus exchange limited to ten cents per $100 could be charged).

[50] *See* Fifth Annual Report of the Federal Reserve Board 332 (1919) [hereinafter cited as Fifth Annual Report]. I have found only a few isolated reports on how many participant banks charged depositors for collection and in what amounts. Aside from the difficulty in finding records, the data might be difficult to interpret because there are various ways to charge for collection. Banks might charge per item collected or by requiring large customers to maintain minimum balances. Differences in charging methods pose difficult, if not insuperable, comparability problems. For example, how would one calculate the charge by a Richmond, Virginia, bank which notified its depositors in 1919 of a fifty-cent charge a month on balances of less than $50 against which as many as five checks were drawn during the month? *See* D. HOFFMAN & M. MILLER, *supra* note 32, at 19.

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2. *Subsidized Collection.* — Until 1918, the collection advantages offered by the Federal Reserve System — payment at par and subsidized shipping of currency to and from the FRB's in connection with the maintenance of reserve balances, were offset somewhat by the fees FRB's charged collecting members, which ranged from one cent (Boston) to two cents (San Francisco) per item.[51] The competitive balance between participants and nonparticipants shifted in 1918, when the FRB's broadened the shipping subsidy and abrogated these service charges.[52] This did not eliminate all charges; the Chicago FRB, for example, still charged fifteen cents for items returned unpaid.[53] Such charges, however, were obviously minor compared with total costs of collection.

The collection subsidy offered by the Federal Reserve System must have changed the terms of competition with respect to collection charges. Even assuming that it was still "legal" for participant banks to charge customers for collection after the FRB's had absorbed the cost,[54] competition for deposits between participants themselves should have forced actual collection charges down to almost zero. Charges would still reflect the remaining actual costs of collection, such as the fifteen-cent returned item charge by the Chicago Reserve Bank and the court-imposed collection risks. Nonparticipants whose collection charges were not subsidized, however, would be the losers.

3. *The Par List Battle.* — At the same time that the Federal Reserve was absorbing collection costs for participant banks, it realized that its attractiveness as a collection system ultimately depended on the value of exchange. As long as nonparticipants' exchange profits exceeded the profits they lost to participants with lower collection costs, banks would still prefer nonmembership. In 1917 and 1918, the Fed greatly expanded its efforts to get nonparticipant banks to put themselves on the "par list" — to agree to pay par on Fed-collected items.[55] The Fed began to demand par on items it sent through the mail. If its requests were refused, it might treat the item as dishonored and return it

[51] G. Anderson, *supra* note 41, at 8–9; W. SPAHR, *supra* note 5, at 177–78.

[52] *See* Fifth Annual Report, *supra* note 50, at 76–77. The increased subsidization occurred when the Federal Reserve Banks agreed to absorb all the cost of postage, expressage, and insurance incident to shipments of currency to and from member banks (not including silver and other coins). The FRB's also absorbed these costs for nonmember banks maintaining clearing accounts. Some saving of expense was also available to nonmember banks on the par list because the FRB enclosed stamped envelopes with collection letters for return remittances. *Id.*

[53] *Id.* at 559.

[54] *See* p. 749 *supra.*

[55] *See generally* W. SPAHR, *supra* note 5, at 243–90.

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to the collecting bank with an explanation. The Fed hoped that the merchant depositor, faced with paying exchange, would demand its drawer-customer to pay with paper written on a par-remitting bank. Customers would then pressure nonpar banks to join the list by threatening to take their deposits elsewhere. This model had certain predictable weaknesses. First, the drawer-customer may have had no alternative but to bank at the drawee — it might be the only bank in town. The drawer could pay the particular merchant with balances held in the merchant's city, but it could not move its entire deposit base. Second, the merchant might be able to defray the higher charges incurred in non-Fed collection uniformly by increasing his prices slightly, to both par and nonpar bank customers.

The Fed also took more aggressive measures to induce banks to join the par list. Relying on the common law and bank depositor contracts which required par payment for items presented over the counter,[56] the Fed hired agents such as the American Express Company to present checks over the counter at recalcitrant banks. This action triggered off various responses from nonparticipant state banks fearful of losing their exchange business. First, they attempted to change the contractual rule that served as the basis for the Fed strategy by putting legends on checks to the effect that the check was invalid if presented through FRB's. Secondly, legislation in a number of states eliminated or limited the duty to pay par over the counter. A number of states imposed an affirmative duty on their own banks to charge exchange.[57] Unsuccessful attempts were again made to get federal legislation allowing all banks to charge exchange against the Federal Reserve, as well as each other. The struggle between the FRB's and the nonparticipant banks eventually found its way into the courts. In *American Bank & Trust Co. v. Federal Reserve Bank*,[58] decided in 1923, Georgia banks sought to enjoin planned over-the-counter presentation by the Federal Reserve Bank of Atlanta. Absent proof of wrongful intent and coercion,[59] the Supreme Court held that FRB's have the same right as any other bank to present a check for payment over the counter.[60] A more serious threat to the par system came

[56] *See* Brookings State Bank v. Federal Reserve Bank, 281 F. 222 (D. Or. 1922); J. BRADY, *supra* note 8, § 154, at 226–27; *id.* § 174, at 252–54.

[57] *See, e.g.*, Act of March 6, 1920, ch. 183, 1920 Miss. Laws 248 (subsequently repealed).

[58] 262 U.S. 643 (1923).

[59] In an earlier round of the case, American Bank & Trust Co. v. Federal Reserve Bank, 256 U.S. 350 (1921), the Supreme Court held that an allegation of coercion by the state bank stated a valid cause of action not dismissable on demurrer.

[60] The only reported case of coercion sufficient to be enjoined was Farmers &

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from the state statutes. In *Farmers & Merchants Bank v. Federal Reserve Bank*,[61] the Supreme Court considered the constitutionality of a North Carolina statute which allowed state banks to pay all checks presented by or through the Federal Reserve, post office, or express company by draft (not specie) unless otherwise indicated by the drawer. The statute also set a minimum exchange fee for remittance. The Court upheld the statute even though its "only purpose . . . was to relieve state banks from the pressure which, by reason of the common-law requirement, federal reserve banks were in a position to exert and thus compel submission to par clearance." [62]

As of 1924, the outcome of the par list battle remained uncertain. The percentage of nonmember banks on the list had moved from 51% in 1919 to 92% in 1921 and back to 83% in 1924.[63] It appeared, however, that as Fed membership expanded, the opportunity for lucrative exchange to offset the higher costs of collection outside the Fed system would diminish. The subsidized par system also offered all participants uniform cost restraints, no collection charges, and payment at par. Within the Fed system, as in the clearinghouse system, competition among participants in economies for out-of-town collection was eliminated, albeit now within the framework of public regulation. With the Fed, however, competition nonetheless remained between participants and nonparticipants.

C. The Risk Differential

Federal intervention into check collection affected not only the bank charges attributable to exchange and general collection costs, but also the charges attributable to risks of collection.

Merchants Bank v. Federal Reserve Bank, 286 F. 566 (E.D. Ky. 1922), where the FRB employed agents armed with pistols and accompanied by dogs to present items, attempted to dissuade depositors from using the drawee bank, and circulated derogatory statements about the bank that resulted in indictments of the agents.

[61] 262 U.S. 649 (1923).

[62] *Id.* at 659.

One of the interesting arguments advanced by the Federal Reserve Bank was that the statute violated the equal protection clause because "other banks with whom it might conceivably compete may demand cash, except in those cases where they present the check through an express company or the postoffice." *Id.* at 661. This, of course, was the real point in the case. While technically the banks were paying par to both state and federal collectors, the paper given to the latter was worth less, given time and availability of money.

[63] *See* W. SPAHR, *supra* note 5, at 247–49 (compiling figures from the annual reports and monthly bulletins of the Federal Reserve Board). Most of the nonpar banks were in the south, although much opposition to par clearance was also evident in Washington, Oregon, Arizona, South Dakota, Minnesota, and Wisconsin. Murchison, *Par Clearance of Checks*, 1 N.C.L. REV. 133, 139 (1923).

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Fed entry changed the four major collection risks: (1) nonpayment in direct forwarding, (2) negligent collecting practices of intermediate banks, (3) acceptance of worthless remittance in payment, and (4) nonpayment attributable to circuitous routing.

1. Initial Regulation: Risks of Direct Forwarding and Intermediate Bank Negligence. — The provisions of the original Federal Reserve Board Regulation J of 1916,[64] which governed the Federal Reserve Banks' responsibility for items collected through them, had three principal features.[65] First, the FRB was to act as the agent of the collecting bank so that any liability incurred within the scope of its authority fell on the collecting bank. Second, the agent FRB was given explicit authority to forward items directly to the drawee for collection. This provision was particularly important since it gave FRB's federal authorization to disregard the judge-made rule that made direct forwarding negligent. Since the depositor in a "Massachusetts rule" state could sue only the FRB for its negligence, the regulation effectively shifted the risk of nonpayment from the FRB back to the depositor. The result was more uncertain in a "New York rule" state. It hinged on whether the depositary bank, which would ordinarily be responsible for a collecting bank's negligence, could also be shielded by its agent's authority under the regulation. Third, the FRB was responsible for its own "negligence." The organizational structure of the Fed, however, shifted the cost of FRB negligence to the public.

Since FRB earnings were regularly great enough to cover the cost of negligence and dividends to member banks, the public bore the risk of FRB negligence through forgone residual earnings. The first share of each FRB's net earnings went to subscribing member banks as a six percent dividend on their stock investment.[66] Remaining net earnings were due to the United States government as a franchise tax, except that one-half of this remainder was to maintain a surplus fund equal to forty percent of the FRB's paid-in capital.[67] Throughout the period from 1918 to 1925, the dividend claims of the member banks were met

[64] *See* H. WILLIS, *supra* note 38, at 1088.

Subsequent versions of the Regulation appear in the series of 1917, *see* 3 FED. RES. BULL. 549 (1917), 1920, *see* U.S. Board of Governors of the Federal Reserve System, Digest of Rulings of the Federal Reserve Board (1914–1923, inclusive) 144 (1924), 1924, *see* 10 FED. RES. BULL. 719 (1924), and 1928, *see* U.S. Board of Governors of the Federal Reserve System, Digest of Rulings of the Federal Reserve Board (1914–1927, inclusive) 177 (1928).

[65] *See* H. WILLIS, *supra* note 38, at 1090.

[66] Federal Reserve Act, ch. 6 § 7, 38 Stat. 251 (1913). Each national bank was required to subscribe to the capital stock of the regional Federal Reserve Bank. *Id.* § 2.

[67] *Id.* § 7.

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comfortably. In 1918, for example, the total profits of all Federal Reserve Banks were $58,875,025, with member bank dividend claims at $5,540,864, or roughly ten percent. The residue went to the surplus account ($21,605,901), and then to the United States ($26,728,440).[68] Since negligence costs in any year were extremely unlikely to exceed the member banks' margin of safety (*viz.*, $58,875,025 minus $5,540,864, or $53,334,161), the risk of FRB negligence fell principally on the public. Thus, member banks must have preferred the FRB's to assume as much of the risk and expense of collection as possible. Even if the members were cheaper cost avoiders than the Federal Reserve, lower costs could not produce higher earnings for the members because of the six percent dividend limitation. Furthermore, the risks borne by depositors and the price paid by depositors for risks borne by the member banks were a term of competition with nonparticipant banks. Shifting risks to the public gave Federal Reserve member banks a significant competitive advantage.

2. *Bad Draft and Circuitous Routing Risks.* — The Supreme Court decision in *Federal Reserve Bank v. Malloy*[69] led, in September 1924, to major revisions in Regulation J that shifted to depositors the risk of nonpayment on account of bad drafts or circuitous routing. In *Malloy,* the Court held that under the "Massachusetts rule" a payee could recover from a Federal Reserve Bank that had accepted a bank draft rather than currency in payment from the drawee bank. The Court refused to construe either the Regulation J provision for direct forwarding or general banking custom as changing the common law rule that acceptance of bank drafts in remittance was negligent.[70] While the authority to engage in direct forwarding relieved the FRB of liability it would otherwise incur for that practice,[71] it did not affect the distinct liability for accepting anything but money in payment. The general custom of taking either currency or drafts in payment was no defense, since the FRB should bear the risk of a choice to which the payee had not consented.[72] In effect, the lack of privity between the payee and the collecting bank barred this defense; the payee and the FRB, which nevertheless could be sued directly, could not contract about the risk.

The *Malloy* decision put the Fed in a difficult position in its struggle to enlarge the par list. If the FRB's were required to accept only currency in order to avoid the risk of bad drafts,

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[68] Fifth Annual Report, *supra* note 50, at 213, exhibit H.

[69] 264 U.S. 160 (1924).

[70] *See* p. 745 *supra.*

[71] *See* pp. 743–44 *supra.*

[72] 264 U.S. at 170.

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one of the inducements for par remittance would be eliminated. Draft remittances insured float for the remitting bank, which would debit the drawer of the check before their correspondent account was debited after FRB presentment.[73] Moreover, the FRB's, now prohibited from accepting exchange drafts in remittance, could no longer undercut the argument that the expense of moving currency in settlement justified exchange charges.[74] Finally, the FRB's were no longer permitted to take the risk — in the effort to facilitate par collection — that the paper they accepted was worthless.[75]

The 1924 revision of Regulation J [76] responded to *Malloy* by pushing more collection risks onto depositors. First, it retained the authorization of direct forwarding which the *Malloy* Court had seemed to accept. Second, in order to negate *Malloy*, the new regulation gave FRB's discretion to accept "either cash or bank drafts" in remittance and absolved them of liability for the drawee's failure to remit or the nonpayment of a bank draft. Third, on its own motion, the Fed gave FRB's additional flexibility in routing by providing that they could forward items to another agent for collection. This provision presumably protected the FRB against circuitous routing liability.

3. The Creation and Consequences of Risk Differential. — Revised Regulation J insulated participant banks in "Massachusetts rule" states, where depositors could sue only the Federal Reserve Bank for agent negligence, from the major risks of collection. Barred from recovery by the FRB's new defenses, depositors had to bear these risks. If the agent FRB's authority sheltered its principals, participant banks in "New York rule" states were in the same position. Nonparticipants, unable to shift risks by contract, had to charge depositors for the cost of bearing them. Thus, to the extent that depositors were more sensitive to price than to risks of unknown dimensions, participants shifting risks to depositors through the operation of federal regulation gained a competitive advantage against nonparticipants. Participants were disadvantaged, however, to the extent

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[73] Such float was not available for members or nonmember participants with Fed clearing accounts because these accounts were debited quite soon after presentment.

[74] *See* W. SPAHR, *supra* note 5, at 241.

[75] There was a genuine paradox in the Federal Reserve Bank's pursuit of par collection. Although the Fed succeeded in getting nonparticipant banks to remit at the face amount of items, it was willing to accept paper whose real worth, given some discount for the probability that the paper would be worthless, might be no more than the face amount less the exchange charge that would otherwise have been imposed.

[76] 10 FED. RES. BULL. 719 (1924).

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that the depositors forced to bear these risks were not efficient in avoiding collection losses. Nonparticipant banks presumably allocated risk, insofar as they could, to the cheapest risk avoider. When the FRB was the cheapest avoider of risks, imposing risks on depositors increased total collection losses in the Fed system and eroded the advantage participants gained by shifting total risk to depositors.

In addition, differences in the collection practices within and outside the Fed could result in differences in total risk generated, quite apart from who bore the risk itself. Consider, for example, the competitive disadvantage of participants with respect to the risk of bad drafts. The heart of the risk is the failure of the drawee bank. It seems improbable that the depositary bank, which has fewer dealings with any given drawee, could have been in a better position than the FRB's to assess the risk of drawee failure. The depositor was even more poorly positioned to avoid the risk. Any incentive for the FRB's to prevent bad draft losses, however, was diminished by their ability to absolve themselves from liability. Moreover, the FRB's had a positive incentive to ignore the risk of failure because of their greater interest in establishing par collection. This objective made FRB's wary of demanding currency in payment lest potential or actual members of the "par list" lose the perceived benefits of remitting drafts. Finally, it was difficult for a governmental agency to make public its judgments about bank solvency through the establishment of a "demand specie" list. With respect to the bad draft risk, then, FRB collection would produce more risks and therefore be more expensive than collection outside the Fed system.

With respect to circuitous routing, however, nonparticipants appeared to be the disadvantaged parties. As the major means of decreasing exchange charges, circuitous routing through correspondents was more commonly practiced by nonparticipants; the total risks of circuitous routing consequently were greater for them. By contrast, one of the main missions of the FRB's was to decrease collection expenses by eliminating circuitous routing. The practice was therefore less likely in the Fed system, despite that fact that the 1924 version of Regulation J gave the FRB's discretionary authority to collect checks by correspondence.

The dual banking system of 1924, then, produced differences in both the quantity of risks — whether risks of bad drafts, direct forwarding, or circuitous routing — and the manner in which they could be shifted to depositors. "Massachusetts rule" and possibly "New York rule" participants imposed all of these risks on depositors through regulatory risk shifting. Nonparticipants had to price these risks to depositors through collection

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charges, at least in states where the courts prohibited contractual risk shifting. FRB's passed on to the public the costs of negligence which other collecting banks passed back to depositary banks and their customers. As to total risk, participants and their depositors probably faced more risk than nonparticipants with respect to bad drafts and direct forwarding, but less with respect to circuitous routing. These risk differentials were important in leading to the American Bankers' Association Bank Collection Code of 1929.

Most of the competitive problems stemming from the differential risk structure introduced by the Federal Reserve's role in check collection could have been handled, of course, through agreements fixing the price that banks charged for risks. By the time of the *Malloy* decision in 1924, however, it appears that agreements like those of the clearinghouses had disappeared, probably for two reasons. First, there was an increasing likelihood that such agreements would be vulnerable to antitrust attack.[77] Second, because participants had lower collection costs than nonparticipants, the former had little interest in surrendering their perceived competitive advantage through a price-fixing agreement. To be sure, there might have been interest in a price-fixing agreement for the risk component of all costs; the differential risk structure cut different ways on different issues for different banks, and no substantial class of bankers had a clear competitive advantage. But the potential application of the Sherman Act probably made overt attempts to reach such an agreement unfeasible.

Since they could not fix prices, banks turned to risk fixing. A rather explicit attempt to fix risks through a short standard bank depositor contract distributed to member banks in 1924 by the American Bankers' Association and drawn up by the General Counsel, Thomas Paton, followed closely on the heels of the

[77] Price fixing had been held illegal in Standard Oil Co. v. United States, 221 U.S. 1 (1911); Addyston Pipe & Steel Co. v. United States, 175 U.S. 211 (1899); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897).

It is surprising that the prior price-fixing efforts of the clearinghouses were not attacked by the government, especially given the Money Trust Investigation's focus on these activities. Planned prosecutions against the New Orleans and New York clearinghouses were dropped. The General Counsel to the American Bankers' Association advised members that the failure to prosecute was due to lack of effect on interstate commerce under the standards articulated in the *Livestock Cases*, Hopkins v. United States, 171 U.S. 578 (1898), and Anderson v. United States, 171 U.S. 604 (1898). 1 T. PATON, PATON'S DIGEST § 1398, at 223 (1926). *Quaere*, however, whether the interstate commercial impact of price-fixing collection charges for interstate collection is not much greater than the effect of restrictions on membership in a livestock exchange.

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Malloy decision.[78] Three features of this contract are noteworthy: it would have (1) placed all banks under the "Massachusetts rule"; (2) authorized direct or indirect forwarding, and perhaps optional circuitous routing as well; and (3) allowed banks to accept drafts or credits as conditional payment in lieu of cash. Private risk fixing through adoption of the standard form did not seem to go very far; there is no evidence of widespread use or acceptance of this form. Its failure should come as no surprise. The ABA was pursuing a path that many state courts had precluded long before. Further, private risk fixing would have been subject to attack under the Sherman Act if the suggested standard form contract were regarded as a form of trade association data dissemination which restrained competition.[79] It was time for the banks to pursue another course, risk fixing through statute.

III. The Bank Collection Code

The American Bankers' Association's Bank Collection Code — the direct precursor of article 4 of the Uniform Commercial Code[80] — was not a codification of the "law merchant," but

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[78] The final version of the form, available to banks in 1925, read as follows:

> In receiving items for deposit or collection, this Bank acts only as depositor's collecting agent and assumes no responsibility beyond the exercise of due care. All items are credited subject to final payment in cash or solvent credits. This Bank will not be liable for default or negligence of its duly selected correspondents nor for losses in transit, and each correspondent so selected shall not be liable except for its own negligence. This Bank or its correspondents may send items, directly or indirectly, to any bank including the payor, and accept its draft or credit as conditional payment in lieu of cash; it may charge back any item at any time before final payment, whether returned or not, also any item drawn on this Bank not good at close of business on day deposited.

1 T. Paton, *supra* note 77, § 1446. *See also* 2 *id.* § 1446a (explaining the provisions).

[79] *See* American Column & Lumber Co. v. United States, 257 U.S. 377 (1921). *But see* Cement Mfrs. Protective Ass'n v. United States, 268 U.S. 588 (1925); Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925).

In United States v. First Nat'l Pictures, Inc., 282 U.S. 44 (1930), the Court found a violation of the Sherman Act when a group of film distributors established local credit committees to disseminate information about exhibitors. The distributors agreed, with certain exceptions, that they would not make films available to new exhibitors who refused to be bound by the existing contracts of the prior owners, or refused to post the cash deposit assessed by the credit committee. If we substitute banks for distributors, depositors for exhibitors, and the suggested ABA standard form contract for the existing contracts between distributors and exhibitors, it would seem that risk fixing through the standard form contract ran a substantial risk of violating the Sherman Act.

[80] *See* U.C.C. § 4-101, Comment. The comments to 10 of the 24 substantive sections in article 4, §§ 4-201 to -214, -301 to -303, -401 to -407, refer to the ABA Code. I do not mean to indicate that article 4 adopted the same substantive provisions contained in the ABA Code.

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principally a mechanism for eliminating the risk differential between participant and nonparticipant banks by allocating all significant collection risks to depositors. Drafted by Thomas Paton, counsel for the ABA, the Code incorporated the provisions of the ABA standard form contract. Completed in 1929 and adopted in eighteen states by 1932,[81] the Code clearly served the interests of banks.[82]

A. Narrowing the Risk Differential

1. Adoption of the "Massachusetts Rule." — Section 2 of the ABA Code rejected the cases holding that a bank which gave its depositor immediate credit for unrestrictedly indorsed items was a purchaser of the paper and a debtor for the amount of the credit.[83] It provided, with certain exceptions, that depositary banks and subsequent collecting banks were the depositor's agents and subagents for collection.[84] The section also allowed agent banks to revoke credits pending settlement.

Section 5 adopted the "Massachusetts rule" as the starting point for further risk allocation by providing that "initial or subsequent agent collecting banks" were liable only for their own

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[81] Steffen, *The Check Collection Muddle*, 10 TUL. L. REV. 537, 540 (1936). The state statutes are cited in *id.* at 540 n.19.

[82] *Id.* at 540; *see* Townsend, *The Bank Collection Code of the American Bankers' Association* (pt. 1), 8 TUL. L. REV. 21, 22 (1933). The irrepressible critic of codes, Professor Frederick Beutel of Tulane University College of Law, called the Code

> one of the most vicious types of class legislation present on the statute books in America, in that it attempts to throw all the risk of the collection process upon the depositors and at the same time preserve for intermediate banks all the rights of the holders in due course of the paper which they are collecting.

Beutel, *The Proposed Uniform Bank Collections Act and Possibility of Recodification of the Law on Negotiable Instruments*, 9 TUL. L. REV. 378, 385 (1934).

Even the Code's drafter, Thomas Paton, admitted that it was designed to serve the banks. Paton, *Bank Collection Legislation*, 46 BANKING L.J. 508 (1929).

[83] *See* Townsend, *supra* note 82, at 24.

[84] ABA CODE § 2, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 557–58, provided:

> Except as otherwise provided by agreement and except as to subsequent holders of a negotiable instrument payable to bearer or indorsed specially or in blank, where an item is deposited or received for collection, the bank of deposit shall be agent of the depositor for its collection and each subsequent collecting bank shall be sub-agent of the depositor but shall be authorized to follow the instructions of its immediate forwarding bank and any credit given by any such agent or sub-agent bank therefor shall be revocable until such time as the proceeds are received in actual money or an unconditional credit given on the books of another bank, which such agent has requested or accepted. Where any such bank allows any revocable credit for an item to be withdrawn, such agency relation shall nevertheless continue except the bank shall have all the rights of an owner thereof against prior and subsequent parties to the extent of the amount withdrawn.

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negligence.[85] Given individual bank responsibility, the Code easily shifted risks to depositors by authorizing banks to engage in otherwise negligent collection practices. These provisions redressed the competitive disadvantage of nonparticipant banks by giving them the same ability to shift risks that participants in "Massachusetts rule" states had secured under Regulation J.

Given a narrowed definition of negligence, banks could have shifted risks to depositors just as well by using the "New York rule," which made the depositary bank liable for intermediate bank negligence. Why then did they choose the "Massachusetts rule"? The drafters' comment to section 5 explained that collection charges to depositors were too small to cover the liability that banks would bear if they were responsible for the conduct of their correspondents.[86] This is a dubious explanation. If the charge were insufficient, it could have been raised. Furthermore, the absolute cost to depositors would be the same under both rules. Even in "Massachusetts rule" states, non-FRB intermediate banks would charge depositary banks to cover their possible liability for negligent processing, and depositary banks would pass the charge to depositors.

Several considerations, however, probably favored adoption of the "Massachusetts rule." First, that rule was a better statutory starting point, given the banks' interest in satisfying consumer demands that were not economically disadvantageous. For a depositor to contract out of the "New York rule," if he so desired, would have proved cumbersome. The bank and its depositor could agree that the bank was not liable for the negligence of its agents, but the depositor hardly could arrange to hold liable subsequent collecting banks with which he was not in privity.

Second, the "Massachusetts rule" starting point made it costly to vary the statutory risk allocation by contracting into the "New York rule." Despite the mandatory language of section 5, courts solicitous of depositors probably would have upheld that part of a "New York rule" contract making the depositary liable for intermediate bank negligence. They were unlikely, however, to

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[85] ABA CODE § 5, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 561–62, provided:

> It shall be the duty of the initial or any subsequent agent collecting bank to exercise ordinary care in the collection of an item and when such duty is performed such agent bank shall not be responsible if for any cause payment is not received in money or an unconditional credit given on the books of another bank, which such agent bank has requested or accepted. An initial or subsequent agent collecting bank shall be liable for its own lack of exercise of ordinary care but shall not be liable for the neglect, misconduct, mistakes or defaults of any other agent bank or of the drawee or payor bank.

[86] *See* 10 C. ZELLMANN, *supra* note 3, at 562 n.5.

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respect that part of the "New York rule" contract that prevented the depositor from suing an intermediate bank directly, particularly where the depositary had failed. The rationale would have been that a contract with the depositary bank could not relieve the intermediate of its statutory liability. If courts entertained such suits against intermediate banks, the intermediate would have to make some charge to the depositary, thereby increasing the charge to the depositor. The depositor, having already paid for the depositary's contractual assumption of risk, would be paying for a double level of protection. Since few depositors were likely to be risk-averse enough to demand that level of protection, the statutory risk-fix was secure under the "Massachusetts rule."

Third, one might suppose that the litigation costs of depositors' suing an intermediate bank for their loss would be higher than those involved in suing the depositary bank directly.[87] If this were the case, however, one would expect competition between banks for large deposits to force them to contract into the cheaper "New York rule." Perhaps one can infer, therefore, that the "Massachusetts rule" provided at least as efficient a starting point for large depositors, often national companies, who could sue intermediates as easily as depositaries. Even if it were a less efficient choice for small deposits, the banks could assume that lack of information and contract costs would deter depositors from insisting on a different rule for their checks. Indeed, the "New York rule" — by encouraging depositors to sue their depositary and forcing it to incur additional expense to recover from the negligent intermediate bank — might have produced inefficiency where total litigation costs exceeded the amount of the item.

Fourth, adoption of the "New York rule" would have deprived participant banks of a competitive advantage. So long as depositors had to sue the FRB's directly for their negligence, the public rather than the participant bank's depositors would bear the liability costs. If depositary banks were liable for FRB negligence, however, they would have to pass the costs to depositors because the FRB's had no reimbursement obligation.

2. *Direct Forwarding and Circuitous Routing.* — Section 6

[87] It was for this reason that the drafters of the Uniform Bank Collection Act, an unenacted alternative to the ABA Code drawn up under the auspices of the National Conference of Commissioners on Uniform State Law in 1934, *see* 10 C. ZOLLMANN, *supra* note 3, at 570, preferred the "New York rule." *See* Steffen, *supra* note 81, at 562.

For a modern case dealing with the same considerations in another context, see Cooper v. Union Bank, 9 Cal. 3d 371, 507 P.2d 609, 107 Cal. Rptr. 1 (1973) (payee whose check is paid on a forged indorsement can sue depositary bank directly, rather than suing payor bank which must then sue collecting bank on its warranty).

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of the ABA Code [88] narrowed the risk differential between participant and nonparticipant banks in two important ways. First, it provided that direct forwarding of items by mail was not negligent. The ABA draftsmen explained this provision by arguing that banking custom had sanctioned the practice of direct forwarding despite the judicial rule that declared it negligent.[89] This is far from persuasive. In fact, the issue was not whether banks should be able to engage in direct forwarding, but whether banks or depositors should bear the risks associated with the practice. By the time the Code was drafted, banks in many states already had responded to the Regulation J provision that absolved FRB's from liability for the practice by securing direct forwarding legislation.[90] The ABA, a moving force in these earlier efforts, had proposed the Uniform Direct to Payor Act in 1919.[91] By 1927, eighteen states had adopted the uniform act and ten others had similar statutes.[92] That such statutes appeared only

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[88] ABA CODE § 6, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 562–63, provided:

> (A) Where an item is received on deposit or by a subsequent agent bank for collection, payable in another town or city, it shall be deemed the exercise of ordinary care to forward such item by mail, not later than the business day next following its receipt either (1) direct to the drawee or payor in the event such drawee or payor is a bank or (2) to another bank collecting agent according to the usual banking custom, either located in the town or city where the item is payable or in another town or city. (B) Where an item is received on deposit or by a subsequent agent bank for collection, payable by or at another bank in the same town or city in which such agent bank is located, it shall be deemed the exercise of ordinary care to present the item for payment at any time not later than the next business day following the day on which the item is received either (1) at the counter of the drawee or payor by agent or messenger or (2) through the local clearing house under the regular established procedure, or according to the usual banking custom where the collecting or payor bank is located in an outlying district. (C) The designation of the above methods shall not exclude any other method of forwarding or presentment which under existing rules of law would constitute ordinary care.

[89] ABA CODE § 6 note, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 563 n.6.

[90] *See* Pierson, *supra* note 3, at 407.

[91] The text of the Act is as follows:

> Any bank, banker or trust company, hereinafter called bank, organized under the laws of or doing business in this state, receiving for collection or deposit, any check, note or other negotiable instrument drawn upon or payable at any other bank, located in another city or town, whether within or without this state, may forward such instrument for collection directly to the bank on which it is drawn or at which it is made payable and such method of forwarding direct to the payor shall be deemed due diligence and the failure of such payor bank, because of its insolvency or other default, to account for the proceeds thereof shall not render the forwarding bank liable therefor, provided, however, such forwarding bank shall have used due diligence in other respects in connection with the collection of such instrument.

Id.

[92] *See id.* at 407–08 & nn.20–47. Two states, Kentucky (1904) and Vermont (1896), approved forwarding of checks "according to the regular course of business" and "in the usual commercial way now in use" before the existence of

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after Regulation J was issued in 1916 is confirming evidence of the thesis that risk differential accounts for the adoption of this bank code. States in which nonparticipation in the Fed system was highest, and thus where the risk differential produced the greatest harm, were most likely to adopt the statutes. In the adopting states, about thirty-three percent of the nonmember banks were nonparticipants; in other states, that figure was only ten percent.[93] The second important provision of section 6 sanctioned limited forms of indirect routing. Although it did not mitigate the greater risks associated with the practice and the consequent disadvantage to nonparticipants, this provision allowed all banks to join in imposing these risks on depositors.

3. Bad Drafts. — The final major collection risk circumscribed by the ABA Code was the one dealt with in *Malloy* — the risk of accepting bank drafts in remittance. Sections 9 and 10 allowed nonparticipant banks to impose the risk of bad drafts on depositors in the same way that participants had been doing under the 1924 version of Regulation J. Under section 9,[94] the collecting bank could accept in lieu of cash payment either the drawee's draft on another bank, a correspondent's draft on a bank other than the drawee, or "such method of settlement as may be customary." Section 10[95] gave the same protection to

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the Federal Reserve System. *Id.* at 408 & nn.48–49. It is unclear whether these statutes authorized direct forwarding.

[93] These calculations are based on data in Fifteenth Annual Report of the Federal Reserve Board 161, table 82 (1928).

[94] ABA CODE § 9, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 563–64, provided:

> Where ordinary care is exercised, any agent collecting bank may receive in payment of an item without becoming responsible as debtor therefor, whether presented by mail, through the clearing house or over the counter of the drawee or payor, in lieu of money, either (a) the check or draft of the drawee or payor upon another bank or (b) the check or draft of any other bank upon any bank other than the drawee or payor of the item or (c) such method of settlement as may be customary in a local clearing house or between clearing banks or otherwise: provided that whenever such agent collecting bank shall request or accept in payment an unconditional credit which has been given to it on the books of the drawee or payor or on the books of any other bank, such agent collecting bank shall become debtor for such item and shall be responsible therefor as if the proceeds were actually received by it in money.

[95] ABA CODE § 10, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 564, provided:

> Where ordinary care is exercised, any agent collecting bank may receive from any subsequent bank in the chain of collection in remittance for an item which has been paid, in lieu of money, the check or draft of the remitting bank upon any bank other than itself or the drawee or payor of the item or such other method of settlement as may be customary: provided that whenever such agent collecting bank shall request or accept an unconditional credit which has been given to it on the books of the remitting bank or on the books of any other bank, such agent collecting bank shall become debtor for such item and shall be responsible therefor as if the proceeds were actually received by it in money.

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banks receiving remittance from any subsequent bank in the chain of collection.

Contemporary arguments that the new rule would relieve depositors of the high cost of shipping currency in remittance[96] are unconvincing explanations for the rule. If the total loss from taking bank drafts rather than currency was actually smaller, competition would force banks to take drafts even though they bore the risk. Indeed, banks commonly did take drafts rather than currency even before the enactment of the ABA Code. Abrogating bank liability for bad draft losses changed neither the total loss associated with the practice nor the final cost to depositors; it merely changed the method of charging depositors for that loss. When banks were liable, depositors paid through a collection charge. Under the statute, depositors paid through the assumption of risk.[97]

The possibility that contracts varying these rules would create a double level of protection discouraged opting out. To be sure, there was no double level of protection where the depositary bank sought to assume the risk that its intermediate banks would take bad paper even though they had exercised "ordinary care." The statute clearly provided that an intermediate bank was not negligent as long as it used ordinary care, so that intermediates would not charge depositary banks for bad draft liability. If, however, a depositary bank sought to assume and price to depositors the risk that the intermediate bank would not exercise ordinary care, the double level of protection would emerge. Courts might entertain suits against intermediates in cases where the depositary bank had failed. To the extent that parties could contract out of the Code's bad draft rule only by furnishing this

[96] *See* Townsend, *The Bank Collection Code of the American Bankers' Association* (pt. 2), 8 TUL. L. REV. 236, 238 (1934).

[97] There may be transaction cost considerations in deciding where the risk will lie initially. One commentator of the period observed:

> [I]t would not be possible for banks to assume the losses that have occurred in the last few years on remittance drafts and still continue to handle without charge the vast quantity of items now being collected through banks. Possibly the alternative of shifting the risk from the bank is the lesser evil.

Turner, *Bank Collections — The Direct Routing Practice*, 39 YALE L.J. 468, 484 (1930). "Although the charge to cover the risk might be small, the mere fact that any charge must be made would increase bookkeeping costs and slow up collection. Just how great this would be does not appear to have been determined as a matter of fact." *Id.* at 484 n.65.

Turner was right in calling attention to the transaction costs involved in choosing an initial liability bearer as between bank and depositor. Even with a charge, however, the depositor might well have preferred to insure for the risk through the bank's assumption of liability. If so, the ABA rule was inefficient in requiring contractual activity to avoid the otherwise applicable statutory rule.

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double protection for which there was no demand, the statutory allocation of risk to depositors was secure.

The bad draft rule did not directly reduce nonparticipant banks' competitive advantage with respect to the practice of taking drafts in remittance. Even under this rule, depositary banks were not wholly indifferent to the carelessness of their agents. Since intermediate banks were still liable for want of ordinary care, they would pass certain bad draft losses back to depositary banks and, hence, to depositors. Depositary banks, therefore, must have found it competitively necessary to reduce these risks by using the services of careful intermediates. Participants in Fed collection, on the other hand, had to live with the level of FRB negligence. The FRB's were likely to use less care than other intermediates both because they were under no competitive pressure and because they had a separate interest in spreading par collection by readily accepting drafts. Depositors of FRB-collected items probably were worse off. They did not pay a passed-through charge, but they were left without a right of action against the negligent FRB.

The ABA Code, however, narrowed the nonparticipant banks' competitive advantage by spreading the risk of bad drafts beyond those parties — the payee-depositor, collecting banks, and intermediate banks — that ordinarily contracted about risks. Section 11 allocated part of the bad draft risk to drawers and previous indorsers of checks. Under prior case law, the drawer was discharged when the drawee bank issued a draft in payment and charged the drawer's account accordingly.[98] The idea was that the drawer paid for the item through the debit to its balance with the drawee. Under section 11,[99] collecting banks could

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[98] *See* cases cited and discussed in Townsend, *supra* note 96, at 247–53. This rule apparently worked in concert with the rule that the taker of bad drafts was responsible for the loss.

[99] ABA CODE § 11, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 565, provided:

> Where an item is duly presented by mail to the drawee or payor, whether or not the same has been charged to the account of the maker or drawer thereof or returned to such maker or drawer, the agent collecting bank so presenting may, at its election, exercised with reasonable diligence, treat such item as dishonored by non-payment and recourse may be had upon prior parties thereto in any of the following cases:
>
> (1) Where the check or draft of the drawee or payor bank upon another bank received in payment therefor shall not be paid in due course;
>
> (2) Where the drawee or payor bank shall without request or authority tender as payment its own check or draft upon itself or other instrument upon which it is primarily liable;
>
> (3) Where the drawee or payor bank shall give an unrequested or unauthorized credit therefor on its books or the books of another bank; or
>
> (4) Where the drawee or payor shall retain such item without remitting therefor on the day of receipt or on the day of maturity if payable otherwise than on demand and received by it prior to or on such day of maturity.
>
> Provided, however, that in any case where the drawee or payor bank

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elect to treat items forwarded directly by mail as dishonored by nonpayment whenever the drawee's remittance proved worthless; by exercising this option, they could hold the drawer liable. When the collecting bank chose not to make this election, however, section 13 [100] of the Code shifted the risk to the depositors and general creditors of insolvent payor or remitting banks. In cases where the drawee had issued drafts and debited the drawer's account, or where an intermediate had remitted by draft, the bank's assets were impressed with a trust in favor of the owner of the

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shall return any such item unpaid not later than the day of receipt or of maturity as aforesaid in the exercise of its right to make payment only at its own counter, such item cannot be treated as dishonored by nonpayment and the delay caused thereby shall not relieve prior parties from liability.

Provided further that no agent collecting bank shall be liable to the owner of an item where, in the exercise of ordinary care in the interest of such owner, it makes or does not make the election above provided or takes such steps as it may deem necessary in cases (2), (3), and (4) above.

[100] ABA CODE § 13, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 566–68, provided:

1. When the drawee or payor, or any other agent collecting bank shall fail or be closed for business by (Comptroller of the Currency and state official to be designated) or by action of the board of directors or by other proper legal action, after an item shall be mailed or otherwise entrusted to it for collection or payment but before the actual collection or payment thereof, it shall be the duty of the receiver or other official in charge of its assets to return such item, if same is in his possession to the forwarding or presenting bank with reasonable diligence.

2. Except in cases where an item or items is treated as dishonored by non-payment as provided in Section 11, when a drawee or payor bank has presented to it for payment an item or items drawn upon or payable by or at such bank and at the time has on deposit to the credit of the maker or drawer an amount equal to such item or items and such drawee or payor shall fail or close for business as above, after having charged such item or items to the account of the maker or drawer thereof or otherwise discharged his liability thereon but without such item or items having been paid or settled for by the drawee or payor either in money or by an unconditional credit given on its books or on the books of any other bank, which has been requested or accepted so as to constitute such drawee or payor or other bank debtor therefor, the assets of such drawee or payor shall be impressed with a trust in favor of the owner or owners of such item or items for the amount thereof, or for the balance payable upon a number of items which have been exchanged, and such owner or owners shall be entitled to a preferred claim upon such assets, irrespective of whether the fund representing such item or items can be traced and identified as part of such assets or has been intermingled with or converted into other assets of such failed bank.

3. Where an agent collecting bank other than the drawee or payor shall fail or be closed for business as above, after having received in any form the proceeds of an item or items entrusted to it for collection, but without such item or items having been paid or remitted for by it either in money or by an unconditional credit given on its books or on the books of any other bank which has been requested or accepted so as to constitute such failed collecting or other bank debtor therefor, the assets of such agent collecting bank which has failed or been closed for business as above shall be impressed with a trust in favor of the owner or owners of such item or items for the amount of such proceeds and such owner or owners shall be entitled to a preferred claim upon such assets, irrespective of whether the fund representing such item or items can be traced and identified as part of such assets or has been intermingled with or converted into other assets of such failed bank.

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check and such owner received a preferred claim.[101] Even if the owner-payee and the drawer could have contracted for a provision like section 11,[102] it would have been impossible for payees to contract with creditors and depositors of the payor or remitting bank. Indeed, not only was the statutory preference one which could not have been secured by contract, it was at odds with contemporary trust doctrine.[103]

4. Other Intermediate Bank Negligence. — To the extent that the Federal Reserve Banks remained liable for negligence not excused by Regulation J, the ABA Code could not reclaim the competitive advantage that participant banks gained through the Fed's ability to charge negligence costs to the public. If, for example, an FRB lost an item in collection because of drawee insolvency during a period of negligent delay in presentment,[104] it would be liable to the depositor under the "Massachusetts rule," and the public would pay the judgment. If a regular intermediate bank were held negligent in the same situation, it would pass its cost back to collecting banks and thus to depositors. Even if the Code absolved the intermediate bank of responsibility for negligence which the FRB's had assumed under Regulation J,[105] the

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[101] Townsend described the effect of this section thus: "Section 13 invaded the field of insolvency administration and arbitrarily created a class of preferred creditors without reference to existing principles and in plain disregard of equitable doctrine and all considerations of fairness." Townsend, *The Bank Collection Code of the American Bankers' Association* (pt. 3), 8 TUL. L. REV. 376, 378–79 (1934).

[102] For example, insurance companies paid by check were advised to inform their policyholders that

> [r]emittance may be made by check or draft subject to the condition that such check or draft may be handled for collection in accordance with the practice of the collecting bank or banks, and that any receipt issued therefor shall be void unless the amount due is actually received by the company.

Dunham, *The Incidence of Loss by Non-Clearance of Checks Through Bank Failure*, 4 A. LIFE INS. COUNSEL PROC. 595, 612, 622 (1930).

[103] *See* note 101 *supra*. For one thing, the preference dispensed with the normal tracing requirement. Even though there was a tendency to dispense with this requirement in suits by the intermediate or forwarder against the drawee, there was still a claim against only the liquid assets of the bank, which the drawer's funds could be said to have gone into or to have preserved. The ABA Code, however, established a preference against all drawee assets including, for example, the bank building. *See* Steffen, *supra* note 81, at 541–44. *See generally* Bogert, *Failed Banks, Collection Items, and Trust Preferences*, 29 MICH. L. REV. 545 (1931); Townsend, *Tracing Techniques in Bank Preference Cases*, 7 U. CIN. L. REV. 201 (1933).

[104] *Cf.* Heinrich v. First Nat'l Bank, 219 N.Y. 1, 113 N.E. 531 (1916) (after crediting customer's account, bank held checks as owner and could not charge customers for loss arising out of drawer's bankruptcy while checks were lost in mail).

[105] Section 8 of the ABA Code provided that "[w]here an agent bank forwards an item for collection, it shall not be responsible for its loss or destruction in transit or, when in the possession of others, for its inability to repossess itself

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depositors of items collected outside the Fed system would pay through the assumption of greater risk. No risk-spreading device like that available for bad drafts could mitigate this participant advantage.

B. The Third-Party Problem

The preference provisions of section 13, which spread bad draft risks, also deal with a third-party problem which could not be solved by private agreement. Given their inability to contract, the conflicting claims of the payee and the drawee's creditors to the insolvent bank's assets had to be solved by an externally imposed rule. The third-party problem, then, suggests a reason for the enactment of commercial statutes which is beyond the risk allocation thesis developed here. It should be noted, however, that this particular third-party problem and the statutory solution grew out of the Fed's increased reliance on direct forwarding with payment in drafts. As long as banks collected in currency through over-the-counter presentment, there was no bad draft problem. Even if an intermediate bank failed while holding remitted currency, claims to the funds were handled by conventional proceeds doctrines.

The ABA Code also dealt with other third-party problems. Section 7, for example, provided that items mailed directly to a solvent drawee or payor bank were deemed paid when the amount was finally charged to the drawer's account.[106] Fixing the time of payment is crucial in litigation between competing claimants to the drawer's funds.[107] Since attaching creditors and other claimants cannot contract for priority, a "law merchant" solution was impossible, and a legal rule was therefore necessary. In contests between payees and drawers who claimed to have

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thereof, provided there has been no lack of ordinary care on its part." ABA CODE § 8, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 563. The comment to this provision asserted that current law was in accord with § 8, but that the provision, by establishing "the non-liability of the bank . . . in a definite provision of law, . . . makes it easier to deal with the depositor" when he has no records of the lost item or will not produce a duplicate. *Id.* at 563 n.8.

If the law actually was as reported, there was no risk differential problem and no reason for the provision. Presumably, collecting banks of both systems could assign risks to depositors. Even if they could not, Regulation J did not impose these risks on depositors for items collected through the FRB's. Despite the commentator's claims, a contract to the effect of the statute probably would have encountered judicial resistance. *See* J. BRADY, *supra* note 8, § 202, at 289.

[106] ABA CODE § 7, *reprinted in* 10 C. ZOLLMANN, *supra* note 3, at 563.

[107] Third-party rights and the timing of payments are, of course, an issue under article 4. *See* U.C.C. §§ 4–303, –213; West Side Bank v. Marine Nat'l Exch. Bank, 37 Wis. 2d 661, 155 N.W.2d 587 (1968); Leary & Tarlow, *Reflections on Articles 3 and 4 for a Review Committee*, 48 TEMP. L.Q. 919, 926–33 (1975).

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stopped payment, however, the need for statutory intervention is less clear. These parties could agree to make stop-payment rights a term of payment.[108] Nevertheless, legitimate third-party problems for which contract inherently offers no solution stand in sharp distinction to the risk allocation problem dealt with above where, had it not been for judicial restraints and the entry of the Federal Reserve, private contract could have allocated risk.

C. Economies of Scale in Risk Allocation

Commercial statutes dealing with bank collections can perform another important function by achieving economies of scale in risk allocation. The allocation of risks for frauds such as forgery, fixed at the time of the ABA Code by the Uniform Negotiable Instruments Law, provides the best example. At common law, the drawee bank was responsible for paying over a forged drawer's signature, and a depositary bank was responsible for paying over a forged indorsement when it took the check directly from the forger and neither drawer nor payee had been negligent.[109] The Uniform Negotiable Instruments Law, enacted in every state by 1924,[110] adopted these common law rules.[111] It is far beyond the scope of this Article to explain why private contract could not have structured the fraud risks associated with negotiable instruments. My strong belief is that most transactors who indorse an instrument like a check do not have time to

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[108] Waiver of stop-payment rights by depositors could have solved possible conflicts between the exercise of that right and third-party claims, but it might also have encountered difficulty in the courts. *See* J. BRADY, THE LAW OF BANK CHECKS § 227, at 365–69 (2d ed. 1926). *But see* cases cited in 6 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1751C, at 4971 n.9 (rev. ed. S. Williston & C. Thompson 1926).

[109] For the law prior to the Uniform Negotiable Instruments Law, see J. BRADY, *supra* note 108, § 149, at 226–29 & n.1. It was unsettled, however, under what conditions a depositary bank could recover from an innocent person who had taken an item from a thief on a payee's forged indorsement. *Id.* § 152.

[110] *See* J. MURRAY, COMMERCIAL LAW 277 (1975). For the background to the Act, see Eaton, *The Negotiable Instruments Law: Its History and Its Practical Operation*, 2 MICH. L. REV. 260 (1904).

[111] UNIFORM NEGOTIABLE INSTRUMENTS LAW § 23 provided:

> When a signature is forged or made without the authority of the person whose signature it purports to be, it is wholly inoperative, and no right to retain the instrument, or to give a discharge therefor, or to enforce payment thereof against any party thereto, can be acquired through or under such signature, unless the party, against whom it is sought to enforce such right, is precluded from setting up the forgery or want of authority.

See also J. BRANNAN, THE NEGOTIABLE INSTRUMENTS LAW § 23 (4th ed. 1926). While § 23 made clear that the drawer and payee could not be charged if their signatures had been forged, it remained uncertain whether the drawee or depositary banks could recover against prior innocent indorsers, whether or not banks, which had taken from the thief. *See* UNIFORM NEGOTIABLE INSTRUMENTS LAW § 62; J. BRANNAN, *supra*, at vii & § 62.

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contract for the rights and liabilities to be attached to their signature. Further, such stipulations probably would render the instrument nonnegotiable, in fact if not in law. The function of the common law in this area, therefore, was to create a standard contract that was later codified.

Of more direct relevance here is the question whether similar contractual difficulties plagued banks involved in the collection and payment of checks, the major species of negotiable instruments. Since banks were in the business of dealing with vast quantities of paper, they had an incentive to develop efficient rules for collection. They also were in privity with at least some parties to the paper — drawer, payee, and other banks. Thus, it was theoretically possible for drawees to contract with drawers about the conditions under which they could debit an account with impunity where the drawer's signature was forged. The bank, for example, might accept liability only when it had not followed reasonable practices in comparing the signatures on the check with a signature on the card or other identification. The payee and his bank could make the same kind of agreement with respect to the risk of forged indorsements.[112] Banks could also contract among themselves to allocate responsibility for paying over a forged signature or indorsement. Even if the drawee and collecting bank were not in a prior contractual relationship, the collecting bank could supply warranties by affixing a "prior endorsements guaranteed" stamp to its items or a drawee could advertise the conditions for payment given to all banks with respect to forgeries. With freedom to contract, competition and the relative cost efficiencies of the parties should have set the terms of payment.

There was, however, no discernible attempt to contract about these risks. The explanation is probably twofold. First, the common law rules incorporated into the Uniform Negotiable Instruments Law probably constituted efficient, and therefore competitively successful, allocations of risk. There is little doubt that the drawee bank, simply by comparing the drawer's signature card with the signature on checks presented for payment, could most cheaply avoid losses arising from forgery of the drawer's signature. For similar reasons, the depositary bank was in the best position to avert losses from forged indorsements. Indeed, in cases where some other party's negligence was primarily responsible for a loss, the Uniform Negotiable Instruments Law excused the party ordinarily liable and held the other party. Banks, of course, were strictly liable for payments on forged

[112] Of course, banks would be unable to contract with prior parties to the instrument with whom they had no contact.

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checks, but strict liability probably was efficient in this instance. It deterred accidents and shifted losses to banks which could spread risks through insurance. In any event, banks charged the costs of these losses to their depositors, and absent a risk differential, all banks faced the same price constraints. Perhaps the banks' failure to contract out of these rules, assuming that they were free to do so under common law, indicates that very few depositors wished to assume these risks themselves.[113]

The cost of providing contractual options is a second possible explanation for the failure to contract out of forgery liability.[114] Suppose that some depositors wanted to assume the risk of forgery and others accepted the statutory allocation of risk. The cost of providing two separate services — collection with and without forgery risk — might prove inordinately expensive. If the drawee bank did not make signature comparisons for collection-with-risk checks, the cost of sorting them through separate channels presumably would be allocated to the depositors choosing that option. These check writers would pay the banks for not verifying signatures, an unhappy state of affairs. On the other hand, if the bank did signature comparisons for both products and charged only the collection-without-risk depositors, there would be a significant free rider and cross-subsidy problem.[115]

Bank-bank contracts could generate similar costs when different banks assumed different risks. Suppose that intermediate bank *X* forwarded items for correspondent depositary banks *A*, *B*, and *C* to drawee banks *Y* and *Z*. Suppose further that *A* guaranteed prior indorsements to *X* and all subsequent parties, *B* guaranteed only to *X*, and *C* furnished no guarantees, while *X* guaranteed prior indorsements to *Y* but not to *Z*. Here, *X* is clearly at risk for forgeries in *B-X-Y* and *C-X-Y* transactions;

[113] I do not mean to suggest that all allocations of risk for forgery under common law and the N.I.L. were clearly efficient. For different views on the question of the banks' rights to recover back against "innocent" takers from thieves (the rule of Price v. Neal, 3 Burr. 1354, 97 Eng. Rep. 871 (1762)), see J. BRANNAN, *supra* note 111, at 556–69 and accompanying notes. For dispute on the question of which bank was responsible where there were both a forged drawer's signature and a forged indorsement on the item, see J. BRADY, *supra* note 108, § 165, at 259–60 & nn.1–2.

[114] Malcolm, in his classic piece, *Article 4 — A Battle with Complexity*, 1952 WIS. L. REV. 265, observes that "[w]ith the tremendous volume of items being handled, bank collections are and must remain a mass production operation. This means that all agreements must be on standard forms, except for the few special cases that do not fit into the standard operation." *Id.* at 277.

[115] While this example assumes that there is a demand for a "new" service, the same problem arises when one wants to calculate and apportion overhead costs to two services at some initial point in time. If offering both products increases overhead costs by a factor of 100 and these costs cannot be attributed to one product, there will be a tendency to offer only one product.

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X is also liable in the *A-X-Y* case if *A* fails. To the extent that *X*'s liability on certain items led to cost avoidance measures, the described pattern of risk differentiation would produce additional costs for separate handling of different items.

The cost of contractual diversity demonstrates the economies of scale in standard risk allocation for fraud. If banks had been left to allocate major collection risks by private agreement, economies of scale might not have been achieved. The unrestrained differentiation of risk may leave everyone worse off. But a standard risk-fix was not the only alternative. A single collection system might have handled two or three alternative risk allocations without incurring prohibitive processing costs. Indeed, distinct switching networks developed by major banks might have offered different risk contracts. Competition between them would have produced the most efficient variation of risks. The establishment of the Federal Reserve System, however, pretermitted the development of competing switching networks through the various local clearinghouses.

D. Uniform and Backstop Law

The need for uniform law was not a major theme in the push for the ABA Code. Eighteen states had enacted the Code by 1932, but there is no evidence that enactment in any state hinged on enactment elsewhere. The major risks allocated by the statute related to the bank-depositor relationship. Since few banks were organized across state lines, no single bank was likely to gain from uniform rules in several states.

With respect to bank-bank problems, such as the bad draft risk dealt with under sections 9 and 10 of the ABA Code, there was a greater need for uniform law. Even assuming fairly workable conflict-of-law rules, intermediate banks would have to deal with paper carrying different risks depending on the paper's state of origin or destination. One must be wary, however, of the argument for uniform law. Often it is nothing more than a political ploy to protect a statutory outcome. Proponents of the statute can divert the attention of a particular legislature from the merits of individual provisions with the argument that any change or revision would destroy uniformity. The availability of such political leverage explains the preference of certain groups for uniform state law rather than federal law, in which the uniformity argument is by definition unavailable.

Since the banks were interested in reallocating risk, arguments for backstop law also played little role in the adoption of the Code. Today, however, the need to backstop contract is

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cited as an important justification for article 4.[116] The basic idea is that even assuming the theoretical adequacy of contract to allocate risks, many parties will fail to contract and leave their disputes to the courts. A related notion is that a commercial statute should not supplant contract entirely but should provide only supplementary legal rules, allowing the parties to contract out of any provision. This backstop justification for commercial statutes involves serious trade-offs. On the one hand, since backstop rules must be optional in order to leave room for the contracts they are meant to supplement, they will undercut a statute's ability to provide for standard allocations of risk. With freedom to contract, parties may produce paper carrying different risks and preclude economies of scale. Contractual variation also diminishes the uniformity of state laws. On the other hand, to the extent that statutory risk allocations are made binding by regarding any variation as an attempt to disclaim responsibility for "lack of good faith or failure to exercise ordinary care," [117] a given legal rule may prevent competition from producing the most efficient allocation of risks. Furthermore, transactors concerned about the validity of contractual modifications will use the established rules in order to avoid the litigation costs of creating alternatives. Even if courts are receptive to contracts, the existence of the rules can constrain bargaining by forcing the party which seeks to alter the rules to justify every departure. In important ways, therefore, an optional rule cannot *merely* backstop contract.

Although regulatory objectives such as the elimination of risk differentials or the protection of depositors can cut against contractual freedom and perhaps justify a commercial statute, the backstop justification is insufficient. That courts must supply the terms that parties fail to provide by contract does not prove the need for a statute to assure risk allocations or safeguard against judicial incompetence in specialized commercial law. The business practice and custom of parties who have contracted about risks may be a better, if less certain, guide for the courts. Whatever certainty a backstop statute affords must be appraised alongside its costs — the possible selection of inefficient rules and the stifling of competition and innovation in the allocation of risk.

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[116] Karl Llewellyn was a particularly strong advocate of this consideration in adopting the Uniform Commercial Code. *See* Llewellyn, *Problems of Codifying Security Law*, 13 LAW & CONTEMP. PROB. 687, 687 (1948); Llewellyn, *Why a Commercial Code?*, 22 TENN. L. REV. 779, 779 (1953). *See also* U.C.C. § 4-103.

[117] U.C.C. § 4-103. It is uncertain which provisions of article 4 of the U.C.C. embody this notion. My guess is that a significant majority of article 4's provisions could not be varied by agreement, but this question calls for a more detailed analysis.

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IV. Private Contract in New Payment Systems

Since the ABA Code rules on check collection were revamped by articles 3 and 4 of the U.C.C. in the 1960's, technology has spawned new payment systems (NPS) — credit cards and various forms of electronic fund transfers (EFT) — which present significant new collection problems not dealt with by existing law.[118] The need to allocate different types of risk has led new payment systems to use private contract in order to structure such risks. This Part, after furnishing some basic descriptions of certain NPS transactions in Section A, examines whether private contract can or will be allowed to structure these risks without statutory intervention of some kind.

Building on the lessons and themes drawn from the origins of statutory check collection rules, Section B suggests that the law on NPS may develop in the following way. First, courts or legislatures probably will intervene to protect depositors against contractual risk shifting by banks. Second, a modern counterpart to the FRB-introduced risk differential may prompt NPS providers to seek statutory risk fixing. If through piecemeal judicial or legislative intervention payment systems come to carry different allocations of risk, financial institutions may seek legislation to fix risk in the same fashion for all systems in order to avoid distortions in demand. Third, certain NPS systems are or may become natural monopolies, a situation pretermitted in the check system by Fed entry into out-of-town collection. Statutory intervention may occur to control the contracts that such monopolies make with merchants, depositors, or among their own member banks. Fourth, statutes may be needed to solve third party problems and to achieve economies of scale in risk allocation where a given NPS does not achieve monopoly scale. Finally, a perceived need for uniform or backstop rules may lead to NPS statutes.

A. Descriptions of Three New Payment Systems

1. Credit Cards.[119] — There are really three types of credit card transactions: (1) seller charge plans, (2) so-called "tripartite" plans, and (3) multi-institution plans. The seller plans involve only the store and the customer. The store issues a

[118] *But cf.* Clarke, *supra* note 4 (arguing that article 4 rules should govern EFT transactions).

[119] *See generally* Interbank Card Ass'n Rules (revised as of March 1977); Western States Bank Card Ass'n Operating Rules (revised as of Jan. 1977); National Bankamericard, Inc., Operating Regulations (revised as of June 1976).

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credit card to a customer which can be used to purchase goods on credit at that store. A tripartite plan involves a single bank, its cardholder, and merchants who have agreed to accept the bank's card. Cardholder transactions with accepting merchants are treated like "on-us" checks.

In the multi-institution transaction, the main focus here, the card-issuing bank supplies cards to its customers and establishes credit accounts on their behalf. The customer need not keep his demand deposit account with that bank. The cardholder incurs obligations to the issuer by using the card to purchase goods or services or to secure cash advances. Typically, the agreement between issuer and cardholder allows the cardholder to choose payment options at the time initial payment is due; he may pay in full within a specified period after being billed without incurring finance charges, or he may pay over time and incur finance charges.

Merchants enter into agreements with merchant member banks that belong to the same system to which the card-issuing banks belong. That is, the merchant contracts with a bank that has a right to present cardholder paper through clearing channels to card issuers for payment. The typical merchant agreement requires the merchant to honor all charge cards issued by member banks of the interchange system as payment for goods or services. For charges above certain amounts ("floor limits"), the merchant must get prior authorization from the issuer or his agent. Authorization may be obtained by telephone or through a terminal at the merchant location which is interconnected by a "switch" with the authorizing member's data files. Having accepted a charge card in a transaction, the merchant usually deposits the sales slip with his merchant member and receives a credit for the item at some agreed-upon discount. The merchant member, after removing on-us items, forwards the sales slips through the interchange system for collection. Each sales slip goes to the issuer bank to be charged to the account of the cardholder who incurred the obligation. Today, the sales slips themselves usually are "truncated," and a description of the transaction is communicated through the same channels in electronic form. The truncation of paper requires "descriptive billing" instead of "country club billing." No longer does the cardholder receive the charge slips from the card-issuing bank, since these slips remain truncated at the merchant member bank or association; instead his statement contains a description of transactions.

BankAmericard (VISA) and Master Charge are the major multi-institutional bank card systems. The Master Charge system is governed by the associational rules of regional organiza-

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tions, which all banks need not join, and the national rules of Interbank, to which all participant banks and regional associations belong. Associational rules control transactions by members of a regional association; Interbank rules control all other transactions. By contrast, in the BankAmericard system, one set of rules promulgated by National BankAmericard, Inc. (NBI), an association of all member banks, governs interchange at all levels.

While clearings between merchant banks and card-issuing banks are subject to mandatory associational rules in both systems, banks can compete over the terms on which they issue cards to customers and discount sales slips for merchants. Several commercial banks in any major area such as New York or Boston will be card-issuing banks for the same bank card system. The amount of discount and the service offered, such as a convenient branch bank or speedy processing, are the significant terms of competition. Association rules, however, impose constraints on the ability of any particular bank to allocate risks between itself and merchants. If, for example, association rules absolve the card issuer of responsibility for an unauthorized transaction when the merchant fails to check the cardholder's signature on a card, the merchant member bank which agrees with a merchant that signatures need not be checked will bear the risk of nonpayment. The merchant member bank, however, is less likely to absorb this risk than it would be if the risk could be passed back to the issuer and hence to the cardholder.

Today, banks can be card issuers or mechant members of both major credit card systems. Master Charge never prohibited such "duality," and NBI's restrictive regulations were modified [120] and finally discarded [121] because of difficulty in complying with the antitrust laws. Since the withdrawal of all restraints on duality in mid-1975, approximately seventy-five percent of NBI's 157 new card issuers have been members of the Interbank Master Charge system.[122] Duality has led to pressures by members for the establishment of common procedures in both systems. As members realize the inefficiency in maintaining two separate systems with substantially identical memberships, the result may be one national bank card system.

2. *Point-of-Sale.*[123] — The point-of-sale (POS) system, per-

[120] Worthen Bank & Trust Co. v. National BankAmericard, Inc., 485 F.2d 119 (8th Cir. 1973), *cert. denied*, 415 U.S. 918 (1974).

[121] *See* note 131 *infra.*

[122] *See* NBI Staff Letter to Member Banks, Feb. 28, 1977.

[123] *See* Interbank Preliminary Rules, Procedures, Standards and System Recommendations (1977); Operating Rules and Regulations of Tyme Corporation (Oct. 20, 1976).

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haps the most technologically advanced form of EFT, is conducted in both single- and multi-institutional configurations. In single-institution POS, the financial institution installs a terminal at the merchant location which is connected with its own computer record of customer accounts. The institution issues a card to its customers, commonly along with a personal identification number (PIN); the card identifies the holder and grants him access to the terminal. Most cards use a coded magnetic stripe as an additional security check. The consumer inserts his card into the retailer's terminal and punches in his PIN, while the merchant punches in pertinent data about the particular purchase. The message is transmitted from the terminal to the computer file of the financial institution, which returns an approval or rejection response to the terminal. If the transaction is approved, the computer promptly debits the cardholder's account and credits that amount to the merchant. Since both the customer and the merchant have an account with the same financial institution, the transaction is like an "on-us" check transaction.

Few multi-institutional POS systems are now in operation. My treatment of this type of transaction draws heavily on the "Tyme" system in Milwaukee, Wisconsin, one of the truly significant pioneers in EFT. A multi-institutional POS system involves the following cast of actors: (1) the merchant, who maintains the terminal and conducts the sales or other banking functions, such as deposits and withdrawals; (2) a merchant member, a financial institution through which the merchant performs electronic fund transfer transactions and which usually holds the merchant's account; (3) a switch, which routes messages between the merchant member and the financial institutions that have either issued cards to customers or hold customers' accounts; (4) the card-issuing member, a financial institution which issues the card and holds the customer account affected by a particular transaction; and (5) the customer authorized to use the card to originate fund transfer transactions acceptable to the system.

With these actors in mind, we can examine a typical POS transaction. The customer uses his card at the point-of-sale in exactly the same way described in the single-institution transaction. The message can be routed in several ways. If the cardholder has obtained his card from a customer member that is also — with respect to the particular merchant — the merchant member, the transaction is an "on-us" transaction; the message goes from the merchant location to the merchant-customer member, which authorizes the transaction and transfers funds by

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debiting the customer and crediting the merchant. If, however, the merchant member is not the customer member, the message is routed from the merchant location to the merchant member, to the switch, and finally to the customer member, which then makes the authorization decision. In some circumstances, the customer member may delegate authorization authority to the switch. Notice of authorization is transmitted back through the switch, to the merchant member, and then to the merchant.

The timing of settlements is decided by the parties involved. Usually, the customer's account is debited immediately, even though settlement to the merchant and between financial institutions may be delayed. Settlement between the merchant member and customer member can be effected in three ways: it can be handled by daily remittance on the net or bilateral credit and debit statements communicated from the switch; it can occur on-line by debiting and crediting correspondent accounts that banks kept with each other at the time of the transaction; or the switch might report net settlement data to the local Federal Reserve Bank for appropriate settlement by debits and credits to reserve accounts.

The legal structure of the multi-institutional POS system consists of a number of contracts. The bank-customer contract and the bank-merchant contract resemble those in single-institution POS, although here they may involve different banks. The association contract between the financial institutions in the system governs message flow and allocation of the risks endemic to the payment system.

3. Preauthorized Debits and Credits.[124] — A third type of NPS, conducted through regional "Automatic Clearing Houses" (ACH's), accommodates preauthorized debits and credits. The system permits consumers to make and receive regularly recurring payments without using checks. Payments of mortgages, insurance premiums, and utility bills and receipts of wages, dividends, social security benefits, and annuities are reflected automatically in consumers' demand deposit or savings accounts.

In a typical preauthorized debit transaction a depositor of bank *A* (receiving bank) wishes to make monthly payments to a utility company that banks at bank *B* (originating bank). The depositor completes an authorization form permitting the company to initiate periodic debits made to his account at the receiving bank. The receiving bank is notified of the authoriza-

[124] *See* New England Automated Clearing House Association Operating Rules (effective April 1, 1977); National Automated Clearing House Association Rules (effective Jan. 1, 1977).

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tion and agrees to process the items. The company contracts with its originating bank to provide for the initiation of debits. Having received debit authorization from the depositors of many banks, the company prepares a magnetic tape that lists the customer accounts and amounts to be debited at various receiving banks and sends that tape to its originating bank for processing. The bank removes debits to consumers who have their accounts with it and credits the company for the total debits. It then sends a new tape containing the remaining items to an ACH for further processing and distribution of individual tapes to the other receiving banks, which will debit their depositors' accounts.

There are presently thirty-two ACH's each in an exclusive region of the country. Each ACH establishes its own operating rules. Some specify, and others indicate, the "standard form" authorization agreements for participating customers as well as the types of contracts that can be signed between companies and their originating banks. Others leave members free to contract within ACH constraints. All ACH's, except those in New York and Chicago, use the computer facilities of the regional Federal Reserve Banks to process clearinghouse transactions. The ACH's effect settlement through Federal Reserve Banks by reporting daily the net settlement position of each of their member banks. The regional associations have created a national organization called the National Automated Clearing House Association (NACHA), which promulgates rules for all interregional exchanges. NACHA rules also provide for net settlement through the Federal Reserve Banks.

B. Sufficiency of Contract

1. Control of Contract for Regulatory Objectives. — Judical invalidation of contracts may impede successful contractual structuring of NPS. Invalidation is most likely when courts perceive that the banks are imposing "onerous" terms on depositors. In the nineteenth-century check cases, courts held that banks could not disclaim liability for their own negligence or that an "ambiguous" contract should be construed against the bank. Armed with new learning about adhesion contracts, modern courts will be even less constrained. Bank customers of this era are also more likely to secure protection through federal and state statutes. There is, therefore, a strong possibility that customers will successfully challenge given terms in NPS bank-customer contracts in one arena or another.

It would be misleading, however, to suggest that the process by which contract gave way to judicial and statutory lawmaking in check collection will be reenacted in the same manner and for

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the same reasons in the area of NPS. Because of a number of important differences between the check payment system and NPS, the latter presents new and different questions regarding the sufficiency of contract as a risk allocation mechanism. Owing to differences in the collection process, for example, the magnitude of collection risks varies among the checking system and each of the new payment systems. With respect to EFT, collection risks are likely to be less significant than in check collection. In on-line EFT systems, like single-institution POS, funds are transferred almost instantaneously from drawer (cardholder) to payee (merchant). The narrowing of this risk will be less pronounced, however, where EFT operates on an off-line or deferred settlement basis, as in multi-institution systems. In ACH transactions, for example, the delay in tape transmission of credits may result in nonpayment of other obligations by the party preauthorizing payment. Risks appear even in POS, since the system must operate off-line when parts of the system are "down."

A second important difference between checks and NPS involves the nature of transactors. In credit card and POS systems, the only payees are merchants rather than all members of the general public, and bank-merchant agreements will allocate the merchant's risk of collection. ACH systems, by contrast, have a more even distribution of payees which includes both the general public's receiving credits for salary and companies' receiving utility payments. Even here, however, merchant contracts are neatly separable from those of consumers generally. Regulatory controls may prevent the contractual allocation of collection risk to consumers, but merchants and banks may be left to contract at will.

In addition to collection risks, all new payment systems run the risk of fraud from stolen or counterfeit cards and computer manipulation of account balances. Responsibility for fraud in NPS can be allocated through the contracts of cardholders and their banks (credit cards and POS), depositors and their banks (ACH), or merchants and their banks (all systems). As an example, consider risk allocation to merchants in a POS transaction. Most agreements establish procedures that the merchant must follow when taking a card in payment. He must, for example, ascertain whether a card has expired, whether it appears to have been tampered with, and whether the customer's signed surname on a receipt corresponds to the name on the card. When he fails to take these precautions, the merchant-merchant bank contracts or the association agreements allocate the risk of card fraud to the merchant. Neither courts nor legislatures are likely to object to this allocation of risk, especially if competing banks

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in the same or different systems offer merchants different terms. In a competitive situation, the merchant will be deemed capable of protecting himself.

Freedom to allocate risks to depositors or cardholders may be a different matter. The Truth in Lending Act [125] already limits the credit cardholder's liability for fraud to fifty dollars in most cases and absolves him of any liability after he has reported the theft or loss of a card. Possible cardholder negligence is deemed irrelevant. Certain states also limit banks' contractual freedom to allocate fraud risks to depositors in POS transactions.[126] The final report of the National Commission on Electronic Fund Transfers suggests replacing contract with statutory provisions,[127] and two bills currently pending in the Congress would do just that.[128]

Finally, two important differences can be identified with regard to the regulatory response to NPS and the statutory intervention in check collection under the ABA Code. First, the intervenors are different. Banks promulgated the ABA Code to shift risks to depositors; consumers seek NPS legislation to shift risks to banks. Each, however, would claim that a type of market failure justifies intervention. Banks could claim that distortions introduced by judicial decisions and Fed entry into check collection required a countervailing risk-fix, and consumers might claim that perfect markets assume a level of knowledge and sophistication which most consumers lack. Second, consumer statutes would fix risks more directly than the ABA Code by denying contractual opting out rather than relying on the force of statutory starting points or secondary deterrents, such as a double level of protection. Statutory commercial law for NPS will have little to do with the "law merchant" since contractual risks are explicitly reversed and merchant practices are, in any event, in their infancy. The consumer insistence on fixing risk allocation does not necessarily result in a distributional gain, since banks will charge consumers, through interest rates or card fees, for the bank's cost in assuming statutorily imposed risks. Con-

[125] 15 U.S.C. § 1643 (1970).

[126] *See, e.g.*, Wis. Comm'n on Banking Rule 14.01 (1977).

[127] *See* NATIONAL COMM'N ON ELECTRONIC FUND TRANSFERS, EFT IN THE UNITED STATES pt. II, at 19–73 (1977). *See also* H. Scott, New Payment Systems: A Report to the 348 Committee (forthcoming, 1978) (recommending the drafting of a "Comprehensive Payment Code" to establish a public law framework for all NPS).

[128] S. 2065, 95th Cong., 1st Sess., 123 CONG. REC. S14,243 (daily ed. Sept. 7, 1977) (the Riegle bill); H.R. 8753, 95th Cong., 1st Sess., 123 CONG. REC. H8609 (daily ed. Aug. 4, 1977) (the Annunzio bill). *See also* 31 C.F.R. §§ 210.1–.10 (1977) (rules applicable to federal recurring payments); 42 Fed. Reg. 31,763 (1977) (amendment to Regulation J applicable to wire transfers).

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sumers as a class can gain marginally if financial institutions are cheaper insurers, but this gain is offset to the extent that banks are more expensive risk avoiders than consumers. If banks are responsible for loss caused by consumer negligence, the system is unlikely to avoid risks most efficiently.

2. *Risk Differential in NPS.* — The Federal Reserve Banks have not yet introduced risk differentials into EFT. The FRB's assume certain liabilities for processing ACH transactions, but the risk absorption is minimal and available to all financial institutions that contract with the Fed banks. A proposed modification of Regulation J would shift to depositors certain ACH transaction risks from which state statutes or court decisions would otherwise protect them,[129] but general access to ACH services by all banks should prevent them from creating a risk differential problem.[130]

Significantly more important than any possible risk differential among various EFT providers is the effect that risk charges to EFT users will have on EFT competition with other payment media, such as checks and credit cards. EFT developed principally to provide a cheaper system of payment. Any significant increase in costs will make consumers, who are less sensitive to assumption of risk than to price, choose other payment systems. If EFT is actually riskier than other payment media, there is a technological rather than a legal constraint on marketability. Higher charges, however, may result artificially when courts and legislatures impose risks on banks or other providers that are not imposed by laws applicable to other payment systems. Perhaps this perception will create pressure for a commercial statute, much like the pressure for article 9 of the U.C.C., that harmonizes risk allocation for all payment media to the extent it is technologically feasible. If consumers are thought better served by imposing EFT risks on financial institutions despite resulting inefficiencies, EFT providers can argue that the same approach should be applied to checks and credit cards on the theory that all payment systems should bear an equal burden.

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[129] *See* 41 Fed. Reg. 30,890 (1976). It is unclear whether savings and loan associations or nondepository institutions providing EFT services are included within the definition of "depositor." *See id.*; Citicorp, Comments on the Federal Reserve Board's Revised Proposal to Amend Regulation J 7–8 (March 1976) (comments submitted to Federal Reserve Board).

[130] Some savings and loan associations, however, had access to the switching services only through participating banks. The Department of Justice has challenged this exclusion under § 1 of the Sherman Act. United States v. Rocky Mountain Automated Clearing House Ass'n, No. 77–A–391 (D. Colo.), *dismissed without prejudice on joint motion*, Wall St. J., Nov. 18, 1977, at 6, col. 3 (upon agreement by defendant to allow savings and loan associations direct membership).

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3. Control of Natural Monopolies. — A major theme in the history of check collection is the degree of Federal Reserve Board control and participation. The entry of the Fed, partly in response to the monopoly power of private clearinghouses, prevented private banks from developing general rules for a system of check collection. We therefore have no experience with the ability of private associations to provide an acceptable legal structure for collection. The issue is now before us. Some new payment systems, like ACH and credit cards, exhibit characteristics of natural monopoly.[131] Monopoly may also become an issue in the more competitive POS area, at least in a given region, if joint venturing efforts continue.[132] We shall be called upon to answer two questions. First, should a federal agency such as the Federal Reserve Board displace the natural monopolies as it did in check collection? Second, even if no federal agency intervenes, should the private rulemaking authority of these associations be curtailed?

In thinking about these questions, one might consider monopoly abuses with respect to risk allocation. Legislation that imposes collection risks on the customer's bank may not achieve consumer objectives if the private association of NPS providers to which the bank belongs has a natural monopoly. The monopoly can always charge the consumer a monopoly price for the assumption of risk. While competition for customers between card-issuing banks might appear to prevent monopoly pricing in most systems, the effect can still be achieved by indirection. Suppose that many merchant members of a credit card association were experiencing difficulty in getting merchants to assume the risk of card fraud even though the merchants were the cheapest avoider of such losses. A card system facing competition from other systems would be forced to keep card fraud risks on merchant members and, in turn, on merchants in order to meet the competing system's prices to users. A monopoly system, on the

[131] There is one ACH per region and one national organization, NACHA. The latter is currently engaged in a pilot program for interdistrict switching. *See* Interregional ACH Exchange Pilot, Procedural Guide (1977) (on file with author). There are, of course, two national bank card systems — National BankAmericard and Interbank, the latter having participant regional associations. But the sweep of "duality," *see* p. 779 *supra*, apparently encouraged by the Department of Justice, suggests we may soon see a single bank card system. *See* Business Review Letter of Assistant Attorney General Kauper to Pillsbury, Madison & Sutro, Oct. 7, 1975 (on file with author); NBI Staff Letter to Member Banks, Feb. 28, 1977.

[132] *See* Business Review Letter of Donald Baker, Assistant Attorney General, to Nebraska Bankers Ass'n, March 7, 1977 (on file with author) (commenting on the Nebraska Electronic Terminal System). *See generally* W. BAXTER, P. COOTNER & K. SCOTT, RETAIL BANKING IN THE ELECTRONIC AGE (1977).

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other hand, could internally reallocate the risk to the card issuers and, thus, to their cardholders through transaction charges or interest rates. This can be done through bank-bank rules, which are concerned primarily with allocating between banks the risks assumed from depositors and merchants. When more risk is allocated to banks at the depositor-bank end of the transaction, more risk will be apportioned at the bank-bank level.[133] More losses will occur because the issuers are unable to prevent them, and consumers will bear higher costs because competing issuers within the system all operate under an association rule preventing risk shifting to the more efficient parties.[134]

Monopoly abuses can also arise with respect to float. The settlement process of the NBI credit card system illustrates the problem.[135] Merchant member banks receive items generated by

[133] This point should be kept in proper perspective. Most rules in articles 3 and 4 of the U.C.C. and in the ABA Code involve allocation of risks between banks and customers. There is much less attention to bank-bank contracts. Even where those relationships are detailed in article 4, *see* U.C.C. § 4-207 (interbank warranties); *id.* § 4-211 (acceptable media of remittance); *id.* §§ 4-213, -109, -301, -302 (payment and settlement), they reflect the customer-bank risk allocations.

[134] An arithmetic example can illustrate this argument. Assume a good has a price (P) of 10¢ without regard to the payment media used. The consumer's base cost — apart from fraud — of paying with a check (B_{ch}) is 8¢, and the base cost of using a card (B_c) is 2¢. Further, assume that the consumer's fraud costs per card transaction (F_c) is 4¢ if the cardholder bears the risk through transaction fees and 1¢ if the merchant bears the risk. This cost difference reflects the fact that the merchants are more efficient than cardholders in averting loss. Finally, assume that the merchant who bears card fraud costs increases the price of merchandise to all transactors, because of inability to price-discriminate, so that check writers have the same fraud cost (F_{ch}) of 1¢ borne by cardholders. Merchants who do not bear card fraud costs have no losses to pass on to consumers, so that persons writing checks to them have fraud costs (F_{ch}) of zero.

In card system I where the cardholder bears fraud costs through fees, the full costs of paying by card and by check are as follows:

Card: $P(10¢) + B_c(2¢) + F_c(4¢) = 16¢$
Check: $P(10¢) + B_{ch}(8¢) + F_{ch}(0¢) = 18¢$

Here, the cardholder will still shop with the merchant and pay by card.

Now assume that a competing card system II allocates fraud risks to merchants. The costs of paying by card or by check at a merchant accepting card II are as follows:

Card: $P(10¢) + B_c(2¢) + F_c(1¢) = 13¢$
Check: $P(10¢) + B_{ch}(8¢) + F_{ch}(1¢) = 19¢$

Given identical goods at two merchant locations, the consumer will prefer to shop with the merchant accepting card II, since 13¢ is the best "goods plus payment media" price available. Noncardholders will still shop with the merchant accepting card I, since his check price is lower, but they will be induced to acquire card II. So, merchants who want the business of card users will join system II.

[135] Similar issues arise in other EFT systems. Consider, for example, the possible float for payroll credits in an ACH transaction. *See* New England Automated Clearing House Ass'n Operating Rules, app. A (effective April 1, 1977) (exchange and processing schedule). Suppose the originating bank (OB) asks a

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merchant sales and forward them to NBI for collection from the card-issuing bank. The NBI national or regional computer center totals up all credits to which a member is entitled in its member bank capacity and offsets against them the debits incurred by the member in its card issuer capacity. The member then receives overnight a computer report of its net settlement position. If the member is a creditor, it obtains payment by drawing a "clearing draft" on NBI and sending it through the normal check collection channels. If the member is a debtor, NBI draws a clearing draft and sends it through banking channels for collection. These items can be settled between NBI and member banks in a variety of ways — through the Fed, local clearinghouses, or correspondent balances. In theory, the NBI bank account has no funds and there is no float in the system. All collections are held, at the end of the day, by the net creditor members. In

company to supply its payroll tape on Monday at 8 a.m. for payments due to employees by 5 p.m. on Thursday. Suppose further that it takes off the "on us" items that morning, so that the company account is debited for the full payroll amount and the "on us" employees are credited (perhaps it could delay the credit until Thursday). It then supplies the processed tape to the ACH by 8 a.m. on Tuesday, the "regular entry run cutoff" time. The tape will be processed into file by the ACH and delivered to all Receiving Banks (RB's) by 6:30 p.m. on Tuesday. Settlement at the Fed between the OB and the RB's will not occur until 5 p.m. on Wednesday, so suppose that the RB's credit their customers for the Thursday payroll at 5 p.m. on Wednesday, the time of settlement. It is quite clear that the OB has enjoyed a considerable float. Some of this could be bargained away. The company could request the OB to delay debiting its account until the moment at which the tape was due at the ACH. Perhaps a company in an even stronger bargaining position could insist on delaying debits for "on us" items until Fed settlement occurred at 5 p.m. on Wednesday. Presumably, member banks are free to bargain about and compete over such arrangements with their merchant customers.

Consider also the preauthorized debit situation. Suppose the merchant bank (OB) delivers the tape to the ACH in time to make the Tuesday 8 a.m. "regular entry run cutoff" time. Just before delivery, the tape is run against the OB's own customers, with offsetting credits to the merchant. The tape is then distributed to the RB's on Tuesday at 6:30 p.m., and the RB's immediately debit their customers. Since Fed settlement will not occur until 5 p.m. on Wednesday, the RB's gain a one-day float. Again, at least in theory, the RB's compete for customers by bargaining away this float. One wonders, however, how well informed customers will be about these matters, even assuming that competing banks will attempt to inform them. Even if bargaining could result in redistribution of float benefits, might one still allow only float attributable to technological system imperatives?

Banks also secure float in check guarantee systems when they immediately place a "hold" on the cardholder's account, although they pay the merchant only after the guaranteed check arrives at the bank somewhat later. Many customer check guarantee agreements provide for such "hold" rights. Some banks back up the "hold" by requiring waiver of the customer's right to stop payment, a questionable practice under article 4. *See* H. BAILEY, THE LAW OF BANK CHECKS § 13.12, at 409–10 (4th ed. 1969).

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practice, of course, the actual balance in the NBI account depends on the speed with which collected items are paid out. Collections appear to occur more quickly than payments, either because collecting banks delay in drawing drafts or because NBI is efficient in getting settlement on net debit members.

Under most merchant-merchant bank arrangements, the merchant receives credit minus discount in its account at the merchant member on the day it deposits the sales slips for collection. The merchant member receives settlement only after transmitting the item to NBI, receiving settlment data, and securing payment on its clearing draft against NBI. One or two days might intervene between the credit to the merchant and the collection from NBI. This merchant float may be reflected in the depth of the discount on merchant paper. In any event, the merchant and the merchant bank would like to receive funds in settlement as quickly as possible. The card-issuing bank would like to delay settlement. Since most banks are both issuers and merchant banks, it is more correct to say that net creditors would like to expedite collection and net debtors would like to delay.

It does not appear that payment occurs as quickly as is technologically feasible. The clearing draft procedure is cumbersome. Since all members of the system could bank with NBI, it could effect settlement between accounts on the basis of daily net settlement data without drawing clearing drafts. Certain net debtor banks, however, may have an interest in preserving systemic delays. If, for example, New York-Florida interchange leaves New York banks in a deficit position, they would like to delay settling with Florida banks for as long as possible.

Who pays for the delay? If merchant members reflect it in their discount on merchant paper, merchants will pay. If merchants do not pay, the customers of Florida banks may pay through lower interest rates on deposits or higher interest loans. Merchants and bank customers cannot get better terms from other banks, because all banks face the same pattern of delays. Since the pattern also occurs in the Interbank system, albeit to a lesser extent, net creditor banks cannot reduce the economic rent demanded by net creditor banks by switching to a more competitive bank card system. Special interchange arrangements sometimes are possible, but only for regional rather than national settlements.

When settlement is delayed in the interest of consistent interchange debtors, the ultimate beneficiaries are the New York cardholders who extend their free period by the length of the billing delay concomitant with the delay in settlement. The pattern of float can have several adverse economic consequences.

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First, New Yorkers will consume more goods than they could in a rational system. This demand distortion can induce related distortions in production. Second, the float is a form of money creation which affects the general economic system by creating inflation. The Fed, of course, can counteract this type of inflationary float in the same way that it corrects other types of inflation, but New Yorkers will still get a distributional gain attributable only to the economic power that net debtor banks exercise within a monopolistic industry.

4. The Third-Party Problem and Scale Economies in Risk Allocation. — The private rule systems that govern NPS cannot deal with third-party problems. A private contract can establish a "final payment" rule, for example, but it cannot bind attaching creditors to that rule. Both the ABA Code [136] and article 4 of the U.C.C.[137] include provisions to deal with this problem. Similar provisions will be necessary for NPS, even where debits are almost instantaneous. A statute might declare, for example, that attaching creditors will receive a priority until the corresponding credit has been given to a merchant.

Economies of scale in risk allocation are already present in NPS, such as ACH and bank card systems. They become, however, a significant regulatory consideration in the POS area as different POS networks with different rules attempt to interact with each other. Rule incompatibility may be intensified by any regulatory provision that requires an EFT provider to share its terminals with others. An example based on a case that recently occurred in Wisconsin illustrates the problem.

Suppose a multi-institutional POS network, A, composed of card-issuing and merchant member banks, with a certain set of risk allocations at the bank-bank, bank-merchant, and bank-cardholder levels. The common currency of the system is the A card. The cardholder, CH_A, can use an A card issued by bank X_A to debit his account at bank Y_A in order to credit merchant M_A at bank Z_A through the A switch. All banks can issue the A card and service merchants. Now, further suppose POS network B with the same structural characteristics. The common currency is the B card. CH_B can use the B card issued by bank X_B to debit his account at Y_B in order to credit merchant M_B at Z_B through the B switch. Now suppose that a cardholder is able to use his A card at M_B as well as M_A locations, and vice versa. A and B switches interconnect. If CH_A goes to an M_B location, he uses his A card with B card symbol, indicating acceptability at the M_B location. The message goes from M_B to

[136] *See* p. 771 *supra.*

[137] *See* U.C.C. §§ 4-213, -303.

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bank Z_B to switch B to switch A to Y_A, which approves the transaction. The authorization and funds transfer return through the same chain. We have a system B merchant M_B and merchant bank Z_B dealing with a system A cardholder CH_A, card-issuing bank X_A, and account bank Y_A. If CH_A's card is stolen, who bears the loss?

The operating rules of systems A and B may have allocated these losses in different ways. Under system A, the merchant bank might bear the loss; under system B, the card-issuing bank might be at risk. We could decide (1) that any transaction touching switch A, whether or not it touches switch B, is governed by A rules, (2) that the conflicts issue is determined by the merchant location, or (3) that it depends on the particular risk involved. Imagine the same problem with five networks interfacing. Several sets of rules may achieve the correct mixture between diversity and economies of scale in risk allocation, but five possibilities create confusion and inefficiency. While the systems may jointly determine which rules to apply, the choice may be transparent to given transactors. A merchant's risk might depend on whether a given switch was involved in a transaction, a matter which he could not determine in advance by inspecting the card. These problems may create a demand for an organizing statute to achieve economies of scale. A statutory solution, of course, prevents the market from developing the best mix of alternative and competing risk allocation systems.

5. *Uniform and Backstop Law.* — The need for uniform state law arises only when contract has failed to achieve the requisite degree of uniformity. In national payment systems such as ACH's, private contract seems equal to the task. It is important to observe, however, that banks engaged in these ACH transactions have not used their national association to establish one set of rules for all interchange. Regional ACH rules differ in some important respects, particularly with respect to authorization procedures, consumer notification of debits varying in amount from the previous one, and consumer reversal rights.

A code enacted to govern national payment systems need not impose any greater uniformity than achieved through contract, although there would be a tendency to adopt a rule that achieved important efficiency or distributional goals in one region in order to spread those benefits to other jurisdictions as well. This, however, does not follow from a need for uniformity, but rather from the desire for a particular rule. In less national payment systems such as POS, the argument for uniform law is equally suspect. Many transactions occur entirely within one jurisdiction, and there is no particular reason why a POS system in Wisconsin

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should have the same rules as a POS system in Nebraska. A real need for uniformity would arise only if the adoption of different rules by individual states made it difficult for national payment systems to elaborate national rules through private contract. If, for example, New York allocated card fraud risks to customers and California did not, the diversity might put a strain on the credit card association's internal risk allocation rules.

Arguments for backstop law in the NPS area are not convincing. First, there is a tension between these arguments for optional rules and the efforts to secure economies of scale and uniformity through rulemaking. Second, the very existence of backstop rules will encourage people to use them, thus stifling competitive variation. Third, systems that resemble natural monopolies, like the ACH and bank card networks, do not need backstop rules, since it pays for them to elaborate private law. If backstop law has any role to play, it is in the POS transaction — the most competitive and differentiated EFT market.

V. Conclusion

The commercial law of bank collections is, on the whole, neither a response to the failure of contract nor an embodiment of the law merchant. Instead, it reflects the desire of transactors to alter the competitive effects of the existing allocation of risk. Commercial legislation becomes the method by which particular interests achieve their substantive objectives, instead of a means by which society develops a rational payments system. This is not to say that the banks are the ultimate victors in the legislative forum. In the NPS area, it is consumers who object to market outcomes and secure statutes to change them.

Interest group legislation, however, is not the only alternative available. In fact, the risk differentials in the commercial payment process that first triggered interest group legislation were due to federal intervention into the structure of check collection. Similar intervention into certain new payment systems now appears likely. If the society has the power to enact sensible legislation in the structural area, there is no a priori reason why it should be powerless when it comes to commercial statutes. The draftsmen of such statutes must carefully identify results that can be justified on efficiency or distributional grounds. Although this Article generally has not undertaken such analysis, it has suggested that public law should adopt similar rules for all payment systems. If it does not, the market's choice of systems will reflect differences in the legal rules attached to them rather than relative technological efficiencies.

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